

energywatch's response to Ofgem's-

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW
SECOND CONSULTATION**

energywatch Price Control Review Second Consultation

Introduction

Thank you for the opportunity to respond to the Price Control Review second consultation document. We believe that there are a number of important issues still to be discussed in the final phase of the review including the customer experience of DN services.

The response will identify some aspects of the customer experience of the networks services that should for part of the objectives of the control (defined in part I). Part II of the response provides comment on the questions posed by the document.

PART I

Objectives of the Price Control

energywatch believes there are four broad objectives associated with network service provision to consumers-

1. Minimum interruption

- Minimum of supply interruptions and when these do occur timely and accurate information should be given
- To greatly improve access to the services one suggested activity:
- Dedicated help and information line, plus press and other resource material for use during power outages

2. Appropriate redress

- Speedy automatic compensation payments for consumers when levels of service fall below agreed standards
- Appropriate standards and measures to allow network operators to make realistic and achievable promises to consumers

3. Maximum access

- Relevant to the gas network.

4. Value for money

- We expect both the capital and operational expenditure to represent value for money for consumers.

PART II

Comments on particular sections of the report

Chapter 3 : Form, Structure and Scope of the Price Controls

The form of the revenue driver and whether it should include a capacity component. In the case of the latter, Ofgem invites stakeholders to submit detailed and quantified proposals of how this would work

We are not convinced that including a capacity component in the revenue driver will better reflect any cost volatility driven by demand or load growth.

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We are concerned that such a driver would give an incentive to DNOs to increase the capacity required to support any connection. This might not be easily verified, as it will relate to the diversity of demand and the capacity already available at that particular point on the network.

The appropriate treatment of NGC exit charges and wheeling charges, EHV charges, non-contestable connection charges and business rates

NGC exit charges and wheeled charges should be brought within the scope of the price control. DNOs will be able to influence the location and costs of assets required for distributed generation and we believe that for an economic, efficient and co-ordinated system they should also be looking at how they can best utilise all sources of electricity, including the size and location of transmission exit points. The issue is not whether they can control these costs specifically, but whether they should have an incentive to control the costs of bringing electricity onto their networks.

EHV customers should be given the same protection as other customers and their charges should be brought within the scope of the price control. Each DNO has to prepare charging methodologies, which will give them the opportunity to lay out clearly for their customers how any site specific issues will be dealt with.

We agree that connections work is an area where there is the potential to develop competition further. Bringing parts of the connections charges within the price control is likely to reinforce the DNOs position and frustrate the development of competition for these services. Instead, we favour the development of a price cap regime to counter the potential for earning excess returns and support Ofgem's proposal to introduce further standards of service in this area.

We continue to believe that the DNOs may have some degree of influence over the business rates they incur and agree that this needs to be considered further when the method for calculating rates is available.

Ofgem's approach to dealing with uncertainty

We agree that it is inappropriate for consumers to pay for costs that may not arise and we can see the benefits of an additional term approach which does not re-open the main control. However, before an additional term is awarded, it should be concluded that:

1. the uncertainty was not anticipated, either fully or in part, in the price control settlement;
2. the DNO has sought to manage the issue as effectively as possible;
- and
3. the costs awarded have been efficiently incurred.

When the price control settlement is finalised, there will be uncertainties about how certain issues will evolve. If companies are to be given comfort about the treatment of specific uncertainties, we would expect the treatment to be even handed, so that, for example, customers would gain from a rise in pension fund values that meant that company contributions could be reduced.

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The treatment of overspend and the balance between incentives to invest and incentives for costs efficiency

The fundamental issue for consumers is that DNOs deliver a standard of service that customers value. Part of that service is being open about spending plans and the anticipated outputs. We support the proposal, therefore, that DNO proposals for large capex projects should be backed up with details of the additional consumer benefits the projects will bring.

Similarly, overspends should pass tests for being efficiently incurred and providing defined outputs before being passed in to the RAV.

The proposed approach to a separate metering price control

The establishment of a price cap for meter asset provision and an average revenue cap for meter operation appear pragmatic. However, the benefits for consumers from this change will depend greatly on the charging methodologies developed by the DNOs and the subsequent development of competition. For example, too low a price cap could inhibit new entry for asset provision, while the average control could permit cross-subsidy. We would therefore wish to see more fully developed proposals for the controls before we would give the approach our support.

4.7 : Quality of service and other outputs

energywatch considers it vital that every aspect of the consumer experience be examined as part of the price control. It is essential that consumer issues and expectations are placed at the forefront of discussions because, after all, if there were no consumers there would be no need for a price control or for network operators.

Consumers generally contact a DNO to advise of a situation such as a loss of supply or a similar emergency, seek advice, for example how to behave during an emergency or seek a particular action such as a new or altered connection. At each point the consumer has a set of expectations which are often borne out of a lack of understanding of the DNOs' processes. energywatch believes it is important that this lack of understanding is reduced through a programme of education and advice.

Alongside this programme there is a real need for a set of standards of performance that are both achievable and realistic for the DNO and meet the expectations of consumers. In certain instances this will mean an extension of existing standards or measures to include other work undertaken by the DNO – for example telephone monitoring to include messaging or MPAS services or the removal of certain exemptions from the guaranteed standards.

Certain consumers have increased expectations, for example priority consumers. energywatch believes that certain actions should be taken to meet these expectations wherever possible but that this cannot be done until there is an agreed definition of what a priority consumer is.

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Guaranteed and Overall Standards of Performance

energywatch agrees that there is little need for the Overall Standards of Performance; companies are now at a point where service levels meet these standards so regularly there is no real need to continue to monitor them. We strongly believe that the GS should remain in place as they provide a clearly defined level of performance and avenue of redress for the customer. The fact that very few GS payments are made is reflective of a lack of knowledge amongst consumer of their rights, the failure of the industry to make automatic payments and a tendency to make goodwill payments rather than GS payments. We would seek a stronger stance from Ofgem on this issue, including the imposition of payments under GS10 where the DNO has failed to make an automatic payment.

We agree that the current trigger of 18 hours for compensation to be paid in the event of a supply interruption in normal weather conditions should remain unchanged as should the level of compensation at £50. We agree in principle that the trigger period should be lengthened in the event of severe weather and where a large number of customers are affected. However we believe that there must be a very clear definition of what constitutes severe weather and what it is reasonable to expect of DNO's in such events. It is before an event that there should be an agreed set of targets for DNOs to achieve and consumers should be advised clearly and regularly of what they can expect in such circumstances. These standards should set out clearly the actions DNOs should take to ensure minimum interruption to supply. If supply is interrupted it should be up to the DNOs to demonstrate that they completed these actions and did everything possible to a) prevent the interruption and b) restore supplies as quickly as possible. If both cases are proven then compensation will not be paid if either is not proven then the DNO will be expected to adequately compensate the consumer.

We do not believe that the costs associated with 'semi-automatic' payments would be prohibitive as we understand the connectivity data to be sufficiently accurate (with the exception of phase data). DNO's should be encouraged to embark on a program to gather connectivity data at a single phase level and make automatic payments wherever possible. In the absence of automatic payments more effort should be made to advise customers of their right to compensation under GS.

We would welcome a review of the arrangements for business customers including the possibility of linking payments to DUoS charges particularly for larger customers. We believe that there should be an education campaign to ensure that business customers are aware of the risks associated with an interruption to supply so that they are better able to mitigate, including taking out insurance or making arrangements for alternative generation. We would not support a reduction of the trigger point for I&C customers if this was not extended to domestic customers. We would consider it to be reasonable for I&C customers to be given longer notice of planned interruptions.

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We welcome a review of exemptions and believe that these should be limited to those situations which the DNO could not predict or reasonably take action to mitigate against. Exemptions for industrial action should be removed, the majority of DNOs now cover more than one former REC area and staff could be drafted from other areas. Exemptions for severe weather should be limited to situations in which the weather fell into a clear definition and which would be considered very unusual for the climate.

We believe that the timescales for investigating voltage complaints is reasonable as it stands however would seek a tightening of the timescales for resolving complaints from the current six months.

We welcome a review of the overall standards and the provision of an incentive framework based on data collection and monitoring. This should be linked to GS reporting to establish the number of GS payments made in relation to the data on supply interruptions.

The Priority Service Register may not be the most appropriate means of identifying customers who need additional help in the event of a supply interruption. Low awareness and take up of the PSR coupled with poor communication about vulnerable customers between suppliers and DNOs make this unreliable. DNOs should explore methods of identifying those customers through liaison with local agencies such as health authorities and social services to ensure that any additional help is directed at those in most need. It is essential that there is an agreed definition of a priority consumer and energywatch is eager to work with industry to establish this.

Protecting worst-served consumers

energywatch endorses Ofgem's proposals to incentivise DNOs to focus on their worst served customers. We recommend that Ofgem

- Develop a definition along the lines suggested in the document (we would prefer the reporting cycle on an annual basis).
- We agree that the ten worst performing circuits is a sensible starting point for this work.
- Publish this information in a way that is useful to consumers

Form of the incentive for interruptions to supply

energywatch would want Ofgem to review the treatment of annual variability in performance to move to a scheme with rewards and penalties in each year.

Use of Deadbands

Whilst we accept that there will be always be the risk of data errors we would expect common sense to prevail in Ofgem's application of reporting standards. We share Ofgem's concerns that deadbands could-

- dampen incentives on companies to meet their targets and
- may complicate the scheme.

Rolling averages

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The use of rolling averages can effectively track trends in DNO performance. However it should be sensible to reserve the right to alter the average by mutual agreement if there are any material external events that necessitate adjustment as a result of for example, severe weather conditions.

Planned interruptions

energywatch would welcome further detail on exactly how Ofgem would calculate the 'interest rate' could be applied to any CIs or CMLs rolled forward as this seems to be the most important aspect of applying the principle of roll over to the control.

The approach to network resilience

We believe it is possible to construct a number of indicators which taken together, capture the concept of resilience. The report from the Network Resilience Working Group defined a number of operations already undertaken by the DNO's that contribute to the networks resilience¹. The report concluded that the "DNOs should consider the application of the appropriate *toolbox* approach to improve network resilience". We believe it should be possible for Ofgem to consider the DNO's investment case using the operations outlined in the report

Management of communications during an event

energywatch favours Option A that does not permit any exclusions from the general telephony incentives. We believe it is possible for the companies to secure increased phone capacity to adequately cope with an emergency if it is limited to a small numbers of networks. The October storms illustrated the wide ranging performance of the distribution networks.

Revising telephony incentives

It is essential that there is continued monitoring of politeness and willingness to help of telephone operators to ensure continued high performance in this area. We do not believe that there is an issue of survey bias as randomly selected customers should represent a good cross section of customer expectations. We believe that automated messaging should be included in the survey as those customers have also received service over the telephone and it is important to take their opinion of that service into account. This may also disincentivise DNOs from maintaining a messaging service in preference for a human response. We also feel that monitoring should be extended to all areas of customer service provided by the DNO e.g. MPAS new connections, etc.

Chapter 5 : Distributed Generation

The approach for assessing and the actual level of the initial values for both the pass-through and the incentive rate under the incentive framework for distributed generation

The impact of distributed generation on DNOs will vary across regions due to the investment plans of developers and geographic factors. DNOs need to

¹ " that included an analysis of weather trends, specifications for worst weather, tree felling for high risk lines, selective undergrounding, insulated conductors, enhanced lightning protection, remote control, additional protection stages, remote indicators for faults, ranking of worst circuits and auto changeover schemes

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be able to respond, so it is appropriate that they receive some incentive to facilitate this environmental objective. As facilitators, they should not be subjected to undue risk, so we favour the 80% pass-through with a lower incentive rate of £2-2.5/kW

Whether incentives should be provided for strategic investment, and if so, the best way of doing so

We anticipate that some parts of the networks in Great Britain would benefit from "strategic investment", so that it opens up opportunities for future development. This could be one of the outputs offered by DNOs when promoting large capex plans, but it would take time for the DNO and its consumers to see the results. We agree that specific capex allowances expose consumers to significant risks and consider that increasing the incentive rate could overly reward a DNO as this would affect all distributed generation connected.

Whether DNOs should be given the option to choose the level of pass-through (and associated incentive rate) proposed by Ofgem

We do not support this as we believe it would only work to the DNOs favour, as they would make the choice with the benefit of unverifiable internal information about the likely level of distributed generation.

The provision of incentives for ongoing network access

The proposal in the document is a starting point, but fails to recognise the penalties incurred by a generator if it fails to supply electricity, either through contracts or through the BSC. We believe the incentive scheme should recognise the value of the connection, which is vital for a generator to stay in business and which can cost a generator far more than the compensation rate being discussed.

The appropriateness of the IFI and RPZ initiatives, including whether the objectives are sound

Given the low R&D Intensity of the DNOs and the strong likelihood of significant change to the operation of DNO networks as distributed generation levels increase, we support the establishment of these initiatives. We are comfortable with the primary objective for the IFI scheme. However, the RPZ scheme should promote the wider implementation of effective strategies, not just the initial demonstration of a novel approach, which could then be ignored.

Whether the IFI and RPZ initiatives will be cost-effective for consumers

The key issue for these initiatives is that they foster genuine opportunities for novel, cost-effective solutions to the connection and operating issues faced by DNOs. This is why we have suggested that the RPZ scheme should have wider implementation included in its objectives, so that consumers see the impact of these initiatives.

Part of the benefit of these initiatives will be the sharing of information between DNOs and other bodies about the challenges they face and the success, or otherwise, of the solutions tried. Transparency will both help the

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information transfer and give consumers confidence that the money is being well spent.

Chapter 6 : Assessing Costs

Publication of DNO information and cost normalisation issues

We welcome Ofgem's attempts at improving the transparency of the process and concur that it is important to have comparable information across the DNOs.

Provided appropriate health warnings are given about potential inconsistencies, and equally about the ways that costs have been normalised, we support the publication of information, both raw and adjusted, that can allow third parties to add their perspectives to the process. The adjusted information can aid comparison, while the differences exhibited by the raw information can prompt pertinent questions.

Ofgem's approach to benchmarking and bottom up modelling

We do not have any comments to make at this time about the technical issues involved. However, we do favour including the quality of supply assessment directly in the modelling, as this is the output that customers experience, rather than having a model optimising entirely around input variables, such as revenues and numbers of customers.

CEPA's TFP productivity study

We do not have any comments to make on this at this time.

Approach to the price control treatment of mergers that occurred before June 2002

The treatment of mergers needs to be worked through in much greater detail, so that these factors are normalised and there is a common understanding. Further, the basis for merger savings needs to be clarified, as the pre-June 2002 policy was based on the achievement of efficiency savings, while the post June-2002 policy uses the loss of a comparator as its justification. This would suggest that both adjustments should be applied.

If only one approach is to be applied, we favour the continuation of the status quo. Companies have seen most of the benefits of merger savings so far, while customers have only started to see benefits, if suppliers have passed them on, in the last year or so.

Ofgem's approach to the roll-forward of the RAV

We concur that customers should not pay twice and we are concerned that despite the extensive work on the Regulatory Accounting Guidelines this issue has only come to light at this time. As discussed above, it is important to have comparable information across the DNOs and the issue of capitalised fault costs illustrates the difficulties in achieving this objective.

Chapter 7 : Financial Issues

The proposal not to strengthen the financial ring-fence in the light of the introduction of a Special Administration regime

Should a DNO become insolvent, the most immediate concern of consumers is that there are no interruptions to the service provided. The proposed Special Administrator regime should satisfy this requirement, however the purpose of the financial ring-fence is to reduce the likelihood of this happening. In the Aquila case, our understanding is that it was not the standard ring-fence that prevented any problems, but an undertaking given by the parent company. We would suggest that Ofgem should review whether the ring-fence is robust to problems that originate from other parts of a group and strengthen the ring-fence as appropriate.

The type and level of trigger that would be appropriate for the cash lock-up mechanism

We support the introduction of a cash lock-up mechanism of the type employed in the Aquila case for all DNOs. However, the issue is finding an indicator that is suitably forward looking and reliable. Credit ratings can often be downgraded after problems have come to light, so we would suggest that a cautious approach is adopted toward the level of the trigger and that the lock-up should be triggerable once the licensee's issuer credit rating has fallen to the minimum rating consistent with investment grade.

Whether Ofgem should adopt a post-tax approach to the cost of capital and whether this should be an industry wide cost of capital with company specific tax allowances directly incorporated into the financial model

We would strongly recommend a pre-tax approach to the cost of capital. We are concerned that the differences between the DNO's taxation policies could potentially distort the calculation of the cost of capital.

If a post-tax basis is adopted, we favour the use of an industry wide cost of capital to reduce complexity and to provide an incentive to companies to manage their tax affairs efficiently.

Whether Ofgem should adopt an assumed level of gearing which reflects the increase in average gearing, and if not, why not

We are concerned that the level of gearing used by Ofgem in determining price controls is not viewed by the DNOs and their financiers as acceptable minimums. Increasing the assumed level of gearing to the current average of close to 70% suggests that in time some companies may seek a gearing level of 80% or greater, which may leave the company sensitive to economic shocks. We would take some comfort if this level of gearing is considered robust by the credit rating agencies, but from the evidence presented so far, we would be wary of using a gearing level above 60-65%.

The proposed treatment of pensions

The mechanics of pensions are very complex and we are aware that pension fund trustees regularly take advice from investment consultants both on carrying out their legal duties and on investment matters. While we can understand the proposals Ofgem are making with regard to pensions costs,

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we cannot comment on their technical merit. However, many companies are sold off or separated each year and we believe Ofgem should take advice on whether their proposals can be viewed as best practice now, and whether they could have been at the time of the last price control, and report back on this.

Indeed, the industry has been the subject of several separations over recent years; e.g. the various descendent of British Gas, the PESs and the supply business sales by MEB and Swalec. We would also suggest that Ofgem should look at the schemes of arrangements produced for these deals and report back on the precedents they offer, if any.

8 : Introducing environmental outputs reporting

We welcome the development of reporting environmental outputs which we think could be a useful addition to current reporting activity as it will enable judgements to be made on the possible influence on pricing any environmental impact has and also provide consumers with information (at least partially) relating to how green their delivered energy is.