



**Electricity Distribution Price Control Review – Policy
Document – March 2003**

A Response by British Gas Trading

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EXECUTIVE SUMMARY

The ex post assessments of efficiency introduced for eligibility to the increased capital expenditure incentives were a valuable contribution to achieving balanced incentives. These can be supplemented by increasing the time period over which a particular Net Present Value of incentive is remunerated to Distribution Network Operators (DNOs) to say 10 years. The effect would be to reduce perverse incentives to defer quality of supply expenditure and should support network resilience. This approach has significant merits over both the existing arrangements and those proposed by Ofgem, i.e. moving most opex to capex whilst at the same time reducing capex incentives further.

FORM, STRUCTURE AND SCOPE OF THE PRICE CONTROLS

Revenue drivers

We remain concerned about an important interaction between losses and the units revenue driver. It is inappropriate to remunerate the theft element of losses via the losses incentive and the units revenue driver; customers will effectively pay twice.

Transmission exit charges

We do not support retaining the pass-through of transmission exit charges.

Treatment of wheeled units

The pass-through of wheeling costs would be a retrograde step and we do not support it. We support including the revenue associated with wheeled units within the price control.

EHV charges

Treating charges for new EHV connections as excluded service revenue appears to limit the benefits of moving EHV charges within the price control. We would welcome clarification of the effect of the proposals compared to the deficient existing regime.

Non-contestable connection charges

We are very disappointed that Ofgem has not taken the opportunity to address the existing problems with the regulation of the current contestable and non-contestable market. We have proposed bringing connection charges within the price control.

Other excluded services

There should be protection for customers connected the ex-Public Electricity Supply (ex-PES, as originally privatised) DNO networks outside their privatised areas at least analogous to that being proposed to customers of new entrant DNOs, i.e. relative price controls, but ideally individual price controls.

Business rates

DNOs should be incentivised to ensure costs are at an appropriately efficient level.

Retention period for efficiency savings

The proposals provide companies with greater capex efficiency remuneration than was set out by Ofgem at DPCR3. All companies will receive unwarranted windfalls whilst those

without accelerated depreciation will be discriminated against. Ofgem's proposals are not in the interests of customers.

We welcome Ofgem's intention to look at asset disposals. Many restructurings are likely to have resulted in the effective disposal of assets by the DNO.

Incentives for investment deferral

We see Ofgem's proposals to reduce the incentives on capex as a radical shift away from incentive regulation towards rate of return regulation, we would caution against this. Such a change requires thorough investigation and consultation and should not be adopted until such a process has been duly undertaken.

Treatment of capex overspends

We welcome Ofgem's proposals which are appropriately symmetrical with under spend.

Losses

We are disappointed with the decision to use a marginal losses incentive scheme whilst also allowing efficient capex expenditure to be allowed in the RAV. Our suggestion was for DNOs to be fully incentivised by setting the allowance at the full value of each unit of loss without separate capitalization.

Price control for metering services

The stranding of assets is a normal consequence of competition and the principle that incumbents should be shielded from normal competitive pressures in the metering market is inappropriate. The use of termination fees in this market will inappropriately inhibit competition.

QUALITY OF SERVICE AND OTHER OUTPUTS

Guaranteed and Overall Standards of Performance (GOSPs)

Scope of exemptions

There is a clear case for removing industrial action from the scope of exemptions.

Automatic payments

We welcome the intention to have DNOs bear the cost of payments, whether or not they are made to customers. This could usefully be extended to the multiple interruptions.

Compensation for business customers

Consideration should be given to the introduction of a compensation regime equivalent to that for customers in gas.

Reviewing IIP

Form of the incentive scheme

We welcome annual rewards and penalties and hope that the incentive rates are symmetrical. The scheme should be extended to the volume of energy unsupplied. We welcome the intention not to introduce deadbands or rolling averages.

Weighting of planned and unplanned interruptions

We welcome the adoption of this suggestion.

Treatment of planned interruptions for the final year of this price control period

In the absence of evidence to substantiate the risk identified by Ofgem, we are opposed both to the amendment of the existing IIP scheme during this control and to DNOs opting in. This should apply to all or no DNOs.

Network resilience

The intention to have DNOs bear the cost of payments, whether or not they are made to customers, should apply to all other categories of events.

Incentives for telephone response

Form of the incentive scheme

We would welcome the removal of the current relative scheme, to one where companies are set individual targets or alternatively a scheme that is based on individual performance informed by the performance of others. We would welcome Ofgem confirmation of the arrangements with respect to telephony during an exceptional event. We do not support exclusions from the telephony incentives.

General discretionary award

There is merit in considering this further. However, symmetrical arrangements have much better incentive properties and are thus more likely to be in the interests of consumers.

DISTRIBUTED GENERATION, INNOVATION FUNDING AND REGISTERED POWER ZONES

From whom should the DNOs recover the allowed DG revenue?

We agree that recovery should be from future generators connecting to the system.

Locking in the incentive rate

The level of the incentive rate will be unsustainable during the course of one price control without the addition of a significant X factor and an avoided cost discount.

Floor and cap on DNO returns

We do not support the setting of a floor at the level of the cost of debt alongside a cap at the level of twice the cost of capital.

Strategic investment

We support Ofgem's proposals not to encourage speculative investment.

Microgeneration

For the time being, microgeneration should be excluded from the proposed DG incentive scheme and addressed by the standard price control framework.

Definitions and reporting

Because of the much higher rates of return on offer for DG compared with elsewhere, care will be need to be taken to ensure that DNOs can not reclassify DG as other expenditure.

ASSESSING COSTS

Mergers

Ofgem should normalize for mergers by adding £12.5m per merger to merged licensees.

FINANCIAL ISSUES

The cost of capital

We understand that current market data points to a lower cost of capital with downward pressure from the risk-free rate, debt premium, gearing and equity β , offset by upward pressure from the equity risk premium. However, our overall position on the cost of capital remains that whilst there is little evidence to point to a lower cost of capital than assumed at the last review, there is a case that it should be a little bit higher than last time although there is little to support the upper limit of 7.2.

Tahir Majid & Roddy Monroe/Regulatory Affairs/British Gas/ 07.05.2004



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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 – Policy Document' 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

1. Introduction

1.5

As we have noted previously there should be greater transparency about the existing Ofgem-DNO working groups. At the very least agendas and minutes of the meetings should be published on the Ofgem website. Ofgem should also consider opening up some of the meetings to other interested parties.

3. Form, Structure and Scope of the price controls

Introduction

3.2 "Where possible, these incentives should be clear and mechanistic – generally avoiding incentives where the reward (or penalty) depends on ex post evaluation of whether a company's action or behaviour was efficient or appropriate."

Whilst generally supportive of the above statement, there will be instances where it is not possible at this point in time to adequately measure all outputs ex ante, consequently it will be appropriate to continue to supplement the above with ex post assessments of efficiency. For example, the periodic review of relative efficiency will be one such ex post assessment where the assessment methodology cannot be said to be clear and mechanistic until such time as the models (especially top down) have stabilised.

3.3

We continue to believe that the ex-post assessments of efficiency (quality of supply and security) that were introduced for eligibility to the increased capital expenditure (cap ex) incentives at the time of the last price control review were a valuable contribution to achieving balanced incentives. As noted in previous responses, we believe that this approach can be further supplemented by increasing the time period over which a particular Net Present Value of incentive is remunerated to Distribution Network Operators (DNOs). For example, by spreading the existing NPV of the opex and capex 5 year incentives over say 10 years. This approach has significant merits over both the existing arrangements and those currently proposed by Ofgem, i.e. moving most opex to capex that has a lower incentive property whilst at the same time reducing capex incentives further.

Many outputs, in particular network resilience, can not be readily (instantaneously) measured. However, network resilience can be regarded as quality of supply (an instantaneous measure) with a time lag, i.e. over time. The greater period over which the efficiency incentive is remunerated to DNOs will increase the likelihood that network

resilience will be revealed, i.e. that the efficiencies are genuine rather than illusory (at the expense of longer term quality of supply).

Form and structure of the price control

Revenue drivers

3.11 “Ofgem proposes to retain the broad form of the existing revenue driver so that it is weighted equally (50:50) between units distributed and the number of consumers – i.e. no capacity based driver will be introduced.”

We remain concerned about an important interaction between losses and the units revenue driver. We believe that it is inappropriate to remunerate the theft element of losses (non-technical losses) via the losses incentive as well as the units revenue driver as a number of problems are likely to arise: -

- The incentive received by DNOs for theft reduction is unrelated to any decision Ofgem is likely to take on the revised value of the losses incentive;
- DNOs will unjustifiably receive a greater incentive for theft reduction (effectively non-technical losses) than for other losses reduction. As we have noted in previous responses, this is likely to mean that the broadly stable level of losses over recent years is likely to have masked a reduction in theft coincident with an increase in other losses (technical losses). Consequently, the environmental effects of DNO activities, per unit consumed, have worsened over time. The actual environmental performance of DNOs is even worse when account is taken of the year on year increase in consumption. DNO remuneration for theft reduction should be no more than for that of other loss reduction, though there are arguments to suggest that it should be even lower.
- Depending on the size of the losses incentive, there is an increased risk that DNO remuneration for theft reduction will be greater than customers’ theoretical willingness to pay, where this is assessed as equivalent to the cost of the unit of energy lost.

To eliminate these distortions, especially that of customers effectively paying for theft reduction twice, the units driver should be reduced to zero and replaced by some other revenue driver. A less satisfactory solution would be to assess the level of theft and make an adjustment to the remuneration due to DNOs via either: -

- The revenue driver; or preferably
- The losses incentive so that in aggregate the DNOs’ increase/decrease in remuneration for changes in losses was no more than the value of the losses incentive, i.e. a theft losses adjustment along similar lines to that proposed by Ofgem for distributed generation (DG).

3.12 “Ofgem also proposes to:

- use the actual number of consumers reported each year by the DNOs as defined in the IIP Regulatory Instructions and Guidance (RIGs);
- and review the weightings applying to the various voltage categories within the units distributed revenue driver.”

In our last response we supported a review of the existing use of a pre-determined number of customers. The existing regime has the advantage of providing incentives for DNOs to increase customer numbers; the drawback is the accuracy/reasonableness of the forecast. What is the rationale for moving to actual customer numbers? In particular, it is not clear what the performance of DNOs has been against the existing regime?

It is appropriate to review the weightings in light of the revealed level of DNO costs.

Price index

3.14

Most assessments of changes in efficiency use either RPI or the GDP deflator as their reference. These two measures broadly move together over time. It is likely that the recent study carried out for Ofgem by Cambridge Economic Policy Associates Ltd¹ (CEPA) used one of these measures as its reference point. There is very little information on how DNOs’ costs move by reference to CPI. CEPA’s work may be invalidated if CPI were adopted for this review.

It would appear appropriate to continue to use RPI for the next price control with a view to reassessing this position at the following price control review when a longer series of CPI data will be available. At that time it should be possible to assess whether or not CPI is a superior reference point for DNO costs.

The scope of the price controls

Transmission exit charges

3.20 “Ofgem does not propose to change the treatment of transmission exit charges at this review.”

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. 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. Consequently, even after allowing for the effects of NGC’s move to a shallower connection charging methodology, the costs over which DNOs have some control can be expected to be material.

¹ Office of Gas and Electricity Markets, Productivity Improvements in distribution network operators, Final report, Cambridge Economic Policy Associates Ltd, November 2003

There are three methods of satisfying demand: -

- Transmission;
- Wheeled units (via another DNO); and
- DG.

Though Ofgem is proposing the minor change of aligning the incentives on DNOs with respect to transmission and wheeled units (though as this will amount to pass through there will be no incentive) there will be differing incentives (not pass-through) on DNOs with respect to DG. This is likely to lead to distortions in the decisions of DNOs – the very rationale provided by Ofgem for removing the relatively minor wheeled units anomaly.

We do not support Ofgem’s proposals for retaining the existing pass-through of transmission exit charges.

Treatment of wheeled units

3.24 “Ofgem proposes to allow the pass-through of the costs associated with wheeling charges.”

The Ofgem proposals have the small advantage of aligning the arrangements between transmission exit and wheeled units. However, as noted above for transmission exit charges, distortions will then arise as compared with DG. As we believe that DNOs should be incentivised for all three controllable costs, Ofgem’s proposals would be a retrograde step and we do not support them.

3.25 “Ofgem proposes to include the revenue associated with wheeled units within the price control.”

We support this change.

EHV charges

3.30 “Ofgem proposes to include EHV charges within the scope of the price control.”

As EHV charges are DNO controllable costs we support the Ofgem proposals for incentivisation as the most effective way of protecting customers from effective monopolies.

3.31 “... is proposed that charges for any new EHV connections made during the next price control period are treated as excluded service revenue until the next review in 2010, when Ofgem would expect to include them within the price control. Ofgem proposes to include EHV charges within the scope of the price control.”

As the costs of existing EHV customers are largely sunk, hence not now controllable, whereas the costs of new connections are controllable, the effect of this proposal appears to offer customers little if any benefit. Ofgem’s clarification of its EHV proposals and the extent to which controllable EHV costs are being brought within the existing price control would be appreciated.

Non-contestable connection charges

3.37 “Ofgem does not propose to change the price control treatment of connection charges in respect of reinforcement for demand consumers for this price control.”

We are very disappointed that Ofgem has not taken the opportunity to address the existing problems with the regulation of the current contestable and non-contestable market by bringing all of connections (demand and generation) within the RPI-X framework. In particular, no suitable justification has been provided by Ofgem for its policy despite there being little prospect of a fully competitive market.

DNOs are obviously monopolies in the non-contestable market and even in the contestable market they are dominant. Overall DNOs have a market share of 97.5%. The greatest level of competition exists in the Low Voltage Connections market where DNOs have a 96% market share. Though competition can be expected to increase over time, competition cannot realistically be expected to have been established by the end of the next price control let alone at the present time. A recent Ofgem publication “Gas and Electricity connections industry – Review Results – Ofgem June 2003” noted respondents concerns that “connection services had not improved over the last 12 months but the price for these services had increased”.

In light of the above, it appears that Ofgem’s policy with respect to connection charges is inconsistent with: -

- The stated aims of the recently published “Ofgem Corporate Strategy – 2004-2007”

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“Metering and connections

2.14 “It is of central importance that price controls remain where competition is not yet effective”

- Ofgem’s proposals for the electricity metering market; and
- Ofgem precedent for introducing supply competition in gas and electricity.

Our detailed comments and a suggested alternative way forward are contained in a separate attachment to this response – marked Appendix A. The views contained in that Appendix were informed by an earlier meeting with Ofgem to discuss our initial thoughts.

The effect of the alternative way forward, by bringing connection charges within the main price control, will be to set a cap on connection costs whilst providing DNOs with the standard capex incentives to efficiency. I.e. customers will be protected by RPI-X incentive regulation until competition is established yet they will still have opportunity to take advantage of competition in the contestable areas. Consideration has also been given to a mechanism to take account of the potential emergence of competition at different rates in the various DNO areas. The lifting of these controls would be subject to a competition assessment.

3.38 “Ofgem proposes to require DNOs to establish and publish a clear schedule of charges” [for non-contestable services].

In light of our comments above about the lack of effective competition even in the contestable market, Ofgem’s proposal should also extend to the contestable market.

3.39 “At present, voluntary standards of performance exist in relation to the provision of connection services – but only for new housing estates. Ofgem considers that these should be extended to cover all new connections ...”

This is a sensible extension of the existing regime. However, it is unclear why voluntary rather than mandatory standards are being proposed. Consideration should be given to including the monitoring of standards within the RIGs so that consistency and accuracy of reporting is achieved.

Other excluded services

3.42 “Ofgem proposes that the treatment of units distributed to embedded networks should be consistent with that for wheeled units, i.e. included within the scope of the price control.”

We agree with this proposal for the same reasons set out by Ofgem for the treatment of wheeled units revenues.

3.43

Currently networks that the ex-Public Electricity Supply (ex-PES, as originally privatised) DNOs operate within their authorised areas are price controlled. Recently, Ofgem introduced relative price controls as an interim measure for new entrant DNOs operating in the ex-PES DNO authorised areas. These relative controls are set by reference to the charges of the ex-PES DNO within that service area. It is Ofgem’s intention that the appropriate enduring form of regulation for these charges should be formal individual price controls. Though we would have concerns if these interim arrangements were left in place for any significant period of time, as this could perversely incentivise the ex-PES DNOs to restructure their charges on a non-cost reflective basis to foreclose the market to new entrants, we support this Ofgem policy framework.

However, it is our understanding that the existing price controls for the ex-PES DNOs only apply to customers within their privatisation service areas. Consequently, no protection (beyond the application of competition law) is therefore available to customers that are connected to these DNOs’ networks outside their own service areas (i.e. in the service areas of other ex-PES DNOs).

We hope that protection for these customers, at least analogous to that being proposed to customers of new entrant DNOs, but ideally that relating to price controls is introduced as part of this price control review. It is likely that in the absence of the suggested additional protection, competition in this connections market will at the very least be distorted to the detriment of customers. In practice though, it could allow opportunities for ex-PES DNOs to effectively foreclose access to the competitive supply market for their connected customers outside their own service areas in favour of the supply businesses of their own affiliated companies. Moreover, in the absence of at least comparable regulation for the ex-PES DNOs, it could be argued that the existing arrangements discriminate against the new entrant DNOs.

Business rates

3.44

As we have previously stated, 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 key to any future incentives in this area will be the new basis of calculating rates.

Hydro-benefit

3.45

We have separately written to Ofgem and the DTI about both the removal of the Hydro-benefit and the subsequent proposals for a supplier levy via the current Energy Bill, most recently on 1 April.

Incentive framework

Retention period for efficiency savings

3.56 Treatment of efficiency savings

Subsequent to our last price control response² where we queried the detailed application of the five-year rolling capex incentive mechanism, we have reviewed the Ofgem documentation published as part of DPCR3. Ofgem's current proposals provide companies with greater capex efficiency remuneration than was set out by Ofgem as part of the DPCR3 settlement. As this greater remuneration was not set out in advance of the efficiencies being made, the remuneration will have had no effect on company behaviour. Consequently, the current proposals will provide all companies with unwarranted windfalls. Additionally, the proposals discriminate against those licensees without accelerated depreciation. Ofgem's proposals are not in the interests of customers.

Our two areas of concern are: -

Concern 1

When Ofgem introduced the increased capex incentives it explained its rationale as: -

Para 5.58³ "The expectation that at a price control review asset values will be rolled forward to the start of the review period using actual capital expenditure, rather than the projections of capital expenditure on which the existing control was based, will tend to reduce incentives on PESs [DNOs] to operate efficiently."

Para 5.59 "The 20 May consultation paper explained that these perverse incentives could be reduced by making a commitment in this price control review to adjusting asset values in the next price control review by actual, rather than projected, spending on a rolling basis after the lapse of a fixed [subsequently set at five] number of years."

² Electricity Distribution Price Control Review – Second consultation – December 2003 - A Response by British Gas Trading 04/05/04 – paragraph 3.62

³ Reviews of Public Electricity Suppliers 1998-2000 – Distribution Price Control Review –Draft Proposals – August 1999

If the commitment to adjusting expenditure on a rolling basis after the lapse of a fixed number of years had not been introduced then DNO incentives to efficiency would have been equivalent to return and depreciation allowances for DPC3 for forecast new capex, i.e.: -

Yr 1 forecast expenditure – 4 ½ years of return plus 4 years of depreciation⁴

Yr 2 – 3 ½ years of return plus 3 years of depreciation

....

Yr 5 - ½ year of return plus 0 years of depreciation

Consequently, to move from the above outturn incentive for capex efficiency to a “rolling basis after the lapse of a fixed number of [five years] years” including the year in which the saving was made requires the DNO to receive an efficiency incentive equal to the price control allowance for year 1 of the price control namely: -

4 ½ years of return plus 4 years of depreciation.

Ofgem has proposed that the capex efficiency incentive should be 5 years of return plus 5 years of depreciation. Consequently the unwarranted DNO windfall for each DNO equates to

½ year of return plus 1 year of depreciation.

Concern 2

When Ofgem tilted (accelerated) the depreciation on the post-vesting assets of some companies, Ofgem noted that:

Para 5.56 – “ PESs [DNOs] would be neutral to this change. ... The tilting of depreciation is not intended to reward or penalise individual companies”

To maintain both the commitment made in relation to the rolling capex incentive and keep DNOs neutral to tilted depreciation would require each DNO to receive a capex efficiency incentive that was equal in Net Present Value terms if tilting of depreciation had not taken place, that is

4 ½ years of return plus 4 years depreciation on an untilted depreciation basis

Ofgem is making no adjustments to the capex incentive mechanism to take account of tilting depreciation. Consequently the additional unwarranted DNO windfall for each DNO with tilted depreciation equates to the difference between the higher return and depreciation values for a tilted depreciation company as compared to an untilted one. As this will provide unwarranted windfalls for only some DNOs, this aspect of Ofgem’s proposals will additionally discriminate against those companies without untilted depreciation, as they would receive a smaller incentive for the same size of efficiency.

3.57

We welcome Ofgem’s intention to look at asset disposals. As we have noted previously, there have been a number of corporate restructurings that have taken place since the start of the last distribution price controls. These have arisen either as a consequence of the Utilities Act “Transfer Schemes” (where distribution and supply activities were separated)

⁴ Return is received in the year of the expected expenditure but as expenditure is assumed to occur evenly throughout the first year, this gives half the full year return of subsequent years. Depreciation is received for the full expenditure from the year after the expenditure.

or following the sale of distribution or supply businesses. Many of these restructurings are likely to have resulted in the effective disposal of assets by the DNO. For example, where properties (or other rights, licences etc) have either been moved out of the distribution business or left behind in another corporate entity (as part of the transfer scheme to separate distribution from supply). It is likely that as a consequence of the ongoing DNO manpower reductions necessitating a reduced property portfolio, shareholders will have subsequently benefited from the sale of some of these properties. Any assessment of the regulatory asset value at the start of the next price control will need to take account of these asset disposals so that customers can share in this increased efficiency.

The approach to deciding on asset disposals and hence reductions to the RAV should include any properties that were previously part of the regulated business and were being used for distribution activities at the time of the transfer, whether or not they are still being used by the DNO.

Other properties that were previously part of the privatized business that cannot clearly be allocated to any other regulated businesses (supply, transmission, generation etc) should be allocated in part to the DNO. There is previous regulatory precedent for deciding the relevant proportion (value) of such other properties that should be allocated to the DNO, for example the valuations of the RAVs of many of the privatized utilities were calculated on the basis of an 'unfocussed approach' following the initial price reviews. Much of this regulatory precedent was established or agreed by previous Monopolies and Mergers Commission enquiries.

Incentives for investment deferral

3.64

Whilst we accept that a common way of reducing capex is to defer investment projects and that this can be an efficient approach where the deferral does not have a detrimental effect on outputs, we also acknowledge the problems associated with recognizing where deferral is efficient and where it is not. However, we see Ofgem's proposals to reduce the incentives on capex as a radical shift away from incentive regulation towards rate of return regulation and, in principle, we would caution against this. As we are unaware of the size of the problem that is being addressed and the likely effectiveness of the Ofgem solution, we cannot offer an informed view. In our opinion such a change requires thorough investigation and consultation and should not be adopted until such a process has been duly undertaken.

Treatment of capex overspends

3.67

We agree with Ofgem's proposals on how to treat capex overspend and support the move

Losses

Incentive mechanism

3.72

See our earlier comments about the interaction with the units distributed revenue driver at paragraph 3.11.

3.73

We are disappointed that Ofgem has decided to proceed with a marginal losses incentive scheme, i.e. incentive based on a proportion of the full value of each unit of loss reduction/increase (for example the cost of each unit of energy) whilst additionally allowing efficient capex expenditure to be allowed in the RAV.

Our preference was for DNOs to be fully incentivised by setting the allowance at the full value of each unit of loss (or a proportion of it if the forward looking efficient costs of loss reduction were estimated to be less than that value) without separate capitalization. This is in effect a losses revenue driver. If this revenue driver had been attached to the capex allowances then the normal capex efficiency incentives would have operated freely.

To ensure that customers do not suffer adversely as a consequence of Ofgem's proposals, Ofgem will need to ensure that the Net Present Value of the DNO losses incentive remuneration plus capitalization of losses expenditure for each unit of permanent loss reduction is no more than the full value of each unit of loss reduction. This will not be an easy task as most capital expenditure is multi-purpose and DNOs will be perversely incentivised to reclassify it as non-loss related expenditure. Our alternative suggestion did not suffer from this significant deficiency nor did it require an ex post efficiency assessment to determine if expenditure should be allowed into the RAV.

Derivation of reported losses

3.76 "Ofgem therefore proposes that reported losses should simply reflect the difference between the estimated volume of electricity entering and exiting the distribution system."

We welcome this change.

Price control for metering services

We are supportive of Ofgem's decision to separate the price controls for metering and distribution. This is likely to enhance the prospects for competition in the potentially competitive metering market.

Stranding

3.85

The stranding of assets is a normal consequence of competition and the principle that incumbents should be shielded from normal competitive pressures in the metering market is inappropriate. There is no good reason why the Distribution Network Operators should be afforded any greater protection than Ofgem are currently proposing. This already

exceeds the protection Transco received when metering competition was being introduced into the gas market. Experience in gas shows that meters have been exchanged in a controlled manner as they reach the end of their useful life, rather than being prematurely replaced leading to meter asset stranding. There is nothing to suggest that the electricity market should be any different and it is our firm view that additional protection for the DNOs is unnecessary.

We believe that if the difference between historic and replacement values is recovered through network charges, then in total this should provide DNOs with sufficient remuneration on historical investments; it will also limit exposure to the stranding of meter assets.

Form of Price Control

3.86

We are supportive of Ofgem's intention to withdraw from prescriptive regulation once effective competition is established. This may mean that some elements of metering will be freed of price control sooner than other areas as time progresses. In the short term we believe that all aspects of MOp and MAP activity should be subject to a price cap.

Ofgem have been seeking to align the regulatory framework in gas and electricity; we see no reason why this principle should not apply here. In gas, an average price cap form of regulation has been adopted as the method of price control; we favour this approach in electricity also. We consider that there is potential for cross-subsidisation through strategic price profiling if an average revenue cap is adopted.

Competitive Market Review

3.87

British Gas has responded separately to Ofgem's recent Electricity metering CMR. We have been key proponents of the move to competitiveness and have only recently appointed three independent Meter Operators. The decisions that Ofgem make around the Metering Price Control will have a profound impact on the development of competition in this market.

When considering the existing competitiveness of the metering market, it is important that it is not only the ability of suppliers to change from one provider to another, the incentives that exist for suppliers to switch provider, and for non-DNO service providers to enter the market must also be taken into account.

One of our key concerns is around the use of termination fees in this market. Termination fees were not used in the gas market and it is our view that they can present obstacles to market liberalisation by increasing costs for new market entrants. Equally, termination fees place the burden of cost wholly on market participants seeking to embrace the competitive model – we consider that this is unfair because competition will ultimately benefit all end users and so it is only right that the initial costs should be shared.

Ofgem's further thinking

3.90

It is our view that the most appropriate solution is to impose price caps on both MOp and MAP activity. We are supportive of Ofgem's proposed approach of a price cap and a non-discrimination provision; however we do not believe that the development of a charging methodology would be an acceptable alternative to a price cap solution. In order to ensure no cross-subsidisation from the more competitive MOp activity and the less competitive MAP activity, Ofgem may want to consider some form of separation to ensure that competitors are not unfairly disadvantaged.

If price controls are to be imposed on 'basic' metering services only, a clear definition of what these 'basic' services are needs to be agreed upon. Our initial view is that a historical definition may be the simplest solution here.

Comments on Appendix 3 – developing a RIA for metering

A price control is essential in the electricity metering market until effective competition has become established. The obligations on DNOs to provide metering services should not be lifted until there are sufficient alternative providers in this market for suppliers to choose from. In the short term, it is likely that all metering activities should be covered by the metering price control.

We note the concern by DNOs around premature replacement of assets. This was also a concern in the gas market but in practice, meters have only been replaced on an aged basis and premature asset replacement has not been an issue there. There is no evidence to indicate that the situation in electricity would be any different. We share Ofgem's view that an appropriately designed price control can mitigate the risk of stranding.

We are supportive of the general principle that a market mechanism is ultimately the best way to secure the interests of diverse parties and that a regulatory solution should only be imposed until the market has been established.

4. Quality of service and other outputs

Guaranteed and Overall Standards of Performance (GOSPs)

Views of respondents

Scope of exemptions

- 4.9 “Most DNOs argued that the industrial action exemption should remain within the exemptions framework, many citing that its removal would increase risk within the regulated business. NGT, as well as some DNOs also argued that removing this exemption may significantly alter the balance of power in trade union negotiations, which may be detrimental to consumers.”

It is hardly surprising that DNOs would want industrial action to remain within the scope of the exemption regime. However, as industrial relations are clearly affected by the actions of DNOs, the effects of industrial action are clearly controllable. DNOs should be incentivised to reduce the effects (if any) of industrial action on customers.

There is a clear case for removing industrial action from the scope of exemptions as it is in the interests of customers. We do not agree with the views of NGT and some DNOs noted above.

Ofgem’s further thoughts

Guaranteed standard on supply restoration

Automatic payments

- 4.14 “A change to current arrangements is proposed to ensure that DNOs do not have an incentive to discourage claims under the 18 hour restoration standard. It is proposed to address this by including an equivalent penalty under the quality incentives for any consumer off supply for more than 18 hours where payment is not made.”

We welcome the adoption of this suggestion. This could usefully be extended to the multiple interruptions standard where there are a significant number of hurdles to compensation.

Compensation for business customers

4.18

Even if the survey does not support the hypothesis that larger business customers are willing to pay for improved standards of service, consideration should be given to the introduction of a compensation regime equivalent to that for customers in gas. The gas arrangements contained in Transco’s network code provide for compensation as the higher of a fixed amount or a multiple of the customer’s charges. This more closely relates customer compensation to the actual loss facing the customer, the charges it is paying and the energy unsupplied.

The effect is that typically domestic customers and smaller business customers receive the fixed amount of compensation whilst larger customers receive higher levels of compensation for the same outage period.

Priority Service consumers

4.19 “Ofgem does not consider that the most effective approach would be to introduce a new Standard of Performance focused on vulnerable consumers.”

We support this approach.

Reviewing IIP

Ofgem’s further thoughts

Worst-served consumers

4.31 “Ofgem proposes to modify the RIGs to introduce a new requirement for reporting the number of consumers experiencing particular frequencies of interruption each year.”

We support this approach.

Form of the incentive scheme

4.35 “Ofgem proposes to retain the incentive scheme for the number and duration of interruptions but move to annual rewards and penalties. Ofgem is not minded to introduce deadband or rolling averages.”

We welcome the move to annual rewards and penalties and hope that the incentive rates are symmetrical. However, consideration should be given to extending the scheme to the volume of energy unsupplied, along the lines of the scheme for transmission. The addition of this third element would better reflect the actual disruption caused to larger customers making for a more balanced set of DNO incentives. As there is to some extent an overlap both between the two existing measures and the proposed additional measure, the aggregate size of any reward or penalty under IIP need not change.

For the reasons set out in our response to the December 2003 consultation, we welcome the intention not to introduce deadbands or rolling averages.

Weighting of planned and unplanned interruptions

4.37 “Ofgem proposes to establish weightings taking account of the results of the consumer survey.”

We welcome the adoption of this suggestion.

Audits and adjusting data for inaccuracy

4.40 “Ofgem proposes that in the next price control period performance data should be adjusted for any inaccuracies identified by the audits.”

We are unsure how this would work in practice. We accept that if accuracy is worse than the limits then DNOs should be suitably penalized. Furthermore, if there is an inherent/systematic bias in one direction or the other in the DNO reporting then again adjustment may be required. However, it is unclear what if any action should be taken if accuracy is within limits. For example, if a DNO has 95% accuracy, does this mean it is 5% too high or 5% too low?

Perhaps a more appropriate way forward would be to set improved accuracy limits or alternatively incentivise such an outcome. However, the current accuracy limits are

unlikely to be sustainable as performance improves and company %age improvement targets become less than the %age [in]accuracy limits.

4.42 “Ofgem proposes that DNOs should be allowed to roll forward up to 2 planned CIs and 3 planned CMLs from 2004/5 to 2005/6 to mitigate this incentive.”

In the absence of evidence to substantiate the risk identified by Ofgem, we are opposed both to the amendment of the existing scheme and to the principle of DNOs opting in, as noted in our last response. This proposal should apply to all or no DNOs.

Network resilience

Ofgem’s further thoughts

4.50

- No severe weather

We would hope that the intention to have DNOs bear the cost of payments, whether or not they are made to customers, would apply to this category as well as “smaller” severe weather events.

- “smaller” severe weather event

We welcome the intention to have DNOs bear the cost of payments, whether or not they are made to customers. This will more closely align the incentives on DNOs to the level of their failure and significantly reduce the impact and possible perversities inherent in non-automatic payment regimes for monopolies. However, we would hope that this proposal would apply to all other categories of events.

Incentives for telephone response

Ofgem’s further thoughts

The survey sample

4.60 “Ofgem proposes the survey will be expanded to include consumers who have their calls answered by an automated message in the next price control period.”

We welcome this proposal.

Form of the incentive scheme

We would welcome the removal of the current relative scheme, to one where companies are set individual targets or alternatively a scheme that is based on individual performance informed by the performance of others – in effect the use of benchmarking techniques to set individual performance targets.

We would welcome Ofgem confirmation of the arrangements with respect to telephony during an exceptional event. We would support allowing no general exclusions from the general telephony incentives as customers would expect a good standard of service at all times, this is especially the case during a severe/exceptional event/outage. However, if a good case could be made to the contrary, consideration could be given to either: -

- Different standards under normal and exceptional circumstances in light of the differing call volumes; or
- A lower weighting to apply to telephone performance during an exceptional event.

General discretionary award

4.75

There is merit in considering this further. However, symmetrical arrangements, rather than schemes that just reward or penalize companies, have much better incentive properties and are thus more likely to be in the interests of consumers.

5. Distributed generation, innovation funding and registered power zones

From whom should the DNOs recover the allowed DG revenue?

5.16. “The total revenue that a DNO can recover under the DG incentive scheme (the pass-through and the incentive rate) should normally be recovered from those generators connecting to the distribution system after 1 April.”

We agree with this proposal.

The value of the incentive rate

It is unclear at this time how the DTI’s replacement for the recently removed Hydro-subsidy will affect the charges of Scottish Hydro-electric distribution, in particular, if it will be used to offset the excess costs of connecting generators rather than just the excess costs of demand customers. If the levy is to be used for non-demand costs then the incentive rate could be reduced.

Locking in the incentive rate

We remain unconvinced by the level of the incentive rate. This is particularly the case as the average level of costs assumed has been arrived at by disregarding the costs of some DNOs that were deemed too low. As DNOs have a long history of initial forecasts on the high side, this Ofgem decision looks strange. Furthermore, distributed generation can be compared to the introduction of a new technology or product. Typically, efficiency improvements for new products far outstrip those of other areas. Consequently, DNOs can be reasonably expected to significantly reduce the costs of DG connection in the early years of connection and hence outperform the Ofgem assumed costs.

As we noted earlier in this response, demand and consequently the security of the network can be satisfied by three interchangeable sources: -

- DG;
- Wheeled units (from other DNO networks); and
- NGC (transmission system).

Therefore, we would expect DG to displace the need for some non Load Related Expenditure required to distribute energy from other DNO networks and from the transmission grid. This view is further reinforced by a review that is underway of the existing engineering standards that will be updated to specifically allow the presence of DG to be taken account of with respect to its security contribution. For example, a 1MW of DG may have a 63% security contribution. In this example, the 1MW of DG would displace the need for 0.63MW of non-Load related reinforcement expenditure.

It is clear from discussions with Ofgem personnel, that no non Load Related Expenditure avoided costs have been discounted from the DG DNO costs estimates (hence incentive rates).

Consequently, we believe that the existing incentive rate without the addition of a significant X factor and an avoided cost discount will be unsustainable even during the course of one price control. We believe Ofgem could do much more to transparently justify the proposed levels of the proposed DG incentives.

Floor and cap on DNO returns

We do not support the setting of a floor at the level of the cost of debt alongside a cap at the level of twice the cost of capital, for the following reasons: -

- In light of our earlier comments on the significant likelihood of DNO DG out-performance, the cap would appear to be overly generous; and
- Symmetrical arrangements have much better incentive properties and are thus more likely to be in the interests of consumers (as per our earlier comments on the IIP scheme);

Strategic investment

5.33

We support Ofgem's proposals not to encourage speculative investment and agree that the enhanced returns should already encourage sensible risk taking.

Microgeneration

5.38 "Views are invited on whether or not the DG incentive should apply to microgenerators"

The recently published Ofgem document on structure of charges notes that there is little evidence to suggest that microgeneration will impose significant costs on the existing DNO network until there is a high level of penetration and that it may even offer benefits in the form of avoiding the need for peak capacity. We would support this view.

This would suggest that for the next price control, microgeneration should be excluded from the proposed DG incentive scheme and addressed by the standard price control framework. This situation could be reviewed at a later date when there are indications that microgeneration is taking off and there are indications that additional costs are likely to be incurred by DNOs.

Definitions and reporting

5.41

Because of the much higher rates of return on offer for DG compared with elsewhere, care will be need to be taken to ensure that DNOs can not reclassify DG expenditure as other expenditure, for example as non Load related capex expenditure.

6. Assessing costs

Mergers

Ofgem's further thoughts

6.23

We are disappointed that Ofgem is now concluding that there is no need to normalize for mergers. This approach is contrary to the rationale that Ofgem has used in the past to introduce the reduction in DNO revenues by £12.5m per merger five years after each merger.

We continue to believe that, in the absence of being able to statistically observe differences between merged and non-merged companies, Ofgem should normalize for mergers by adding £12.5m per merger to the combined costs of merged licensees. To do otherwise would discriminate against non-merged companies and would perversely incentivise companies to merge, which again is contrary to Ofgem's previous merger policy. It is hardly surprising that merged companies would be opposed to such a fair normalisation.

7. Financial Issues

The cost of capital

7.17

Risk Free Rate

We understand that recent evidence, provided by the last 3-4 years data, suggests that the risk-free rate is well below the range quoted. Whilst we also understand that the Competition Commission put forward the view that spot rates should not be used to determine the risk-free rate we question the use of 3% as an appropriate upper range and request that Ofgem publish details of what is driving the higher rate relative to DPC3 when the converse may be expected.

Debt Premium

We understand that recent evidence points to a debt premium of between 1% – 1.5% and question the rationale behind the proposed higher limit of 1.8%.

Gearing

We understand that credit rating agencies consider that the debt to RAV gearing in the range of 60% to 65% is consistent with target A3 (A-) ratings for comparable regulated network businesses and that this has informed Ofgem's proposal to increase the upper limit of gearing from 50% to 60%. We also understand that Ofgem propose to introduce incentives on companies to move to a capital structure consistent with this by basing the minimum assumed gearing level at 60% (thus capping the tax allowance at 40% equity) and using actual gearing levels for companies with higher than the 60% level (thus passing any additional benefits back to customers during this price control).

We believe that this approach will strike the right balance between customers and shareholders and therefore should be adopted.

Equity Risk Premium

We note that the equity risk premium mid point is similar to DPC3 but the range has widened considerably. This is consistent with the ranges adopted by the Competition Commission in the recent BAA and mobile phone cases where a 3.8 mid point was chosen. We consider that the DPC3 mid point may now be on low side as stock market volatility is significantly higher.

Equity Beta

Evidence points to a lower β than at the last review as supported by the Smithers and Co. report which estimated max β 0.7 (page 17 of Background information on the cost of capital). Whilst in theory there may be a case for increased business risk affected by the size of the capital programme we believe that this is not evidenced by the market.

Corporation Tax Rate

We support the use of actual corporation tax payments, however we have concerns regarding the transparency of actual DNO performance against expectation. We understand that in DPC3 DNOs consistently outperformed the marginal tax allowance of 30% that was allowed although we are unaware of any Ofgem analysis detailing the extent of this. Further we are concerned that there does not appear to be any mechanism in place to pass this previous out performance back to customers. We would urge Ofgem to make this matter more transparent by publishing actual performance against the marginal tax rates assumed.

Conclusion

We understand that current market data points to a lower cost of capital with downward pressure from the risk-free rate, debt premium, gearing and equity β , offset by upward pressure from the equity risk premium. However, our overall position on the cost of capital remains that whilst there is little evidence to point to a lower cost of capital than assumed at the last review, there is a case that it should be a little bit higher than last time although there is little to support the upper limit of 7.2. We accept that there is an upward risk associated with the increased size of the capital programme that will impact on the asset β , however we also note that there is a downward pressure resulting from the increase in gearing.

Tahir Majid & Roddy Monroe/Regulatory Affairs/British Gas/ 06.05.2004

Demand connections costs/revenues and DPCR4

Follow-up to Ofgem meeting
of 6 April, 2004

Tahir Majid – Centrica
6 May, 2004

Demand Connections

- Current position
- Ofgem proposals
- Alternative way forward

Current position – #1 - overall framework

- Standard or special connection agreements
- Up front connection charges with Operation & Maintenance (O&M) uplift
 - Includes replacement of assets in O&M uplift?
 - DNO specific boundary shallow or shallowish
 - Possible Ofgem determination of charges following complaint
 - ‘Second comer’ regulations for shared use infrastructure
- Residual costs capitalised and recovered via DUoS charges
- DNO specific contestable versus non-contestable split

Current position - #2 - assessing costs

- Ofgem assesses load related expenditure (load specific plus general growth) requirements (based on DNO forecasts?) say £600m p.a. (DPCR3 outturn)
- Ofgem assesses connection revenues (based on DNO provided proportions of historical costs) say £400m p.a. (Total connections market 2002/3 415,000 connections = £372m)
 - But part of excluded services and not main RPI-X price control hence effective DNO cost pass through with limited efficiency incentives
- Residual expenditure added to capex allowances – say £200m p.a.
 - Part of main RPI-X price control hence standard capex efficiency incentives apply

Current position – #3 - incentives

- At setting price control perverse incentives for DNOs to deflate forecast connection revenues and hence inflate residual (load related capex) to maximise out-performance opportunities
- During price control
 - Incentives to minimise 'real' costs and maximise revenues
 - No cap on prices hence perverse incentives to maximise connection revenues via maximising
 - Overheads – via inflating or minimising allocation elsewhere to get opex/capex efficiency incentives – customers pay twice
 - Reclassify non-load related expenditure as load related to maximise connection costs and minimise main price control costs to benefit from opex/capex efficiency incentives – customers pay twice
 - O&M costs – no transparent or challengeable methodology – and set at today's costs with no regard to future cost reductions – no guarantee of any future expenditure – anyway probably get O&M costs via future load related capex revenues - hence customers pay twice or more
 - Mark-ups (margins) – set at too high a level to reflect actual risk being undertaken
 - Where adverse Ofgem 'determination' difference can be capitalised anyway

Current position – #4

- Gas and Electricity connections industry – Review Results – Ofgem June 2003
 - Limited competition though DNOs still dominant (over 97.5% share by number)
 - “connection services had not improved over the last 12 months but the price for these services had increased”

Ofgem proposal

- Shallow connection charges – common boundary across DNOs
- Continue extending competition
- Connection receipts to exclude O&M charges
- No changes to price control treatment
- No justification provided for Ofgem policy despite little prospect of a fully competitive market

Alternative way forward - #1 - Negligible competition in connections model

- Ofgem assesses efficient level of load related expenditure requirements (based on DNO forecasts?) say £550m p.a. (assumed £50m p.a. reduced requirement for O&M costs as future control period costs excluded)
- Total load related expenditure added to capex allowances
- Capex allowances reduced by actual connection receipts say £300m p.a. (assume move to shallow charges and O&M removal will reduce receipts by £100m p.a.)
- Hence residual capex allowances say £250m p.a.

Alternative way forward - #2 - Competition in connections model

- Ofgem assesses efficient level of load related expenditure requirements (based on DNO forecasts?) say £550m p.a. (assumed £50m p.a. reduced requirement for O&M costs as future control period costs excluded)
- Ofgem assesses connection revenues (based on DNO provided proportions of historical costs adjusting for move to shallowish connection charges) and expected levels of competition say £300m p.a. (assume move to shallow charges, competition and O&M removal will reduce receipts by £100m p.a.) and added to capex allowances adjusted for actual number of connections carried out by DNO to take account of unpredictable competition impact - as per opex revenue driver proposals - capex allowances reduced by actual number of DNO connections (effectively netting off receipts from capex allowances)
- Residual expenditure added to capex allowances – say £250m p.a.
 - A variant will be to adjust these allowances by actual number of connections to take account of unpredictable load related requirements
- Control removal subject to competition assessment

Alternative way forward #3

- Pros
 - As all load related expenditure is part of main RPI-X control standard capex efficiency incentives apply to all costs including connection charges
 - Perverse incentives described in slide “Current position – incentives #3” removed
 - As DNOs are monopolies in non-contestable market and dominant in contestable market, customers protected by RPI-X incentive regulation until competition established yet still have opportunity to take advantage of competition in the contestable activities
 - Policy also consistent with: -
 - Ofgem corporate strategy (page 9, para 2.14, “It is of central importance that price controls remain where competition is not yet effective”)
 - Proposals for electricity metering price controls
 - Precedents for introducing gas and electricity supply competition
- Cons
 - More complicated?

Demand connections costs/revenues and DPCR4

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