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**BY E-MAIL**

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Dear Nienke,

**Electricity Distribution Price Control Review**

Attached is the energywatch's response to the March Policy document issued by Ofgem.

As Ofgem's document seeks to set out the broad policy framework, the response follows this lead and deals with the high-level principles, supplemented with some tactical comments, rather than critique details, such as the forecasts presented for each distribution network operator.

The response is in three parts. The first section is an executive summary of the key points in the response, the second creates a picture of the outcomes the price control should be facilitating, while the third section provides specific comments on the questions raised and proposals set out in the policy document.

Yours sincerely

**Dr Sebastian Eyre**  
**Policy Advisor**  
***energywatch***

# **Electricity Distribution Price Control Review**

## **energywatch's response to Ofgem's Policy Document**

**May 2004**

### **Summary**

energywatch is broadly supportive of the approach laid out in the Policy Document; however there are elements of the package where we believe the interests of consumers need to be more strongly reflected. Our key points are as follows:

1. Consumers expect to receive a high quality service which improves over time;
2. the price control is a major input to achieving improvements in quality of supply, such as reducing interruptions, more effective communication and decreasing the environmental impact;
3. We are particularly interested in the regular, public measuring of service delivery where they interface directly with consumers;
4. incentives need to be strong enough to encourage companies to capture improvements and balanced so that service aspirations, not accounting policies, drive Distribution Network Operator (DNO) behaviour;
5. the policy framework also needs to incentivise genuine improvements, rather than poor forecasting;
6. the difficulties in determining the link between capex and outputs means that work on this issue should be ongoing now, so that it can be used in future processes;
7. the approach to metering price controls must primarily facilitate effective competition in supply;
8. we welcome the move toward semi-automatic compensation arrangements for supply interruptions, but the level of compensation for business customers needs to be improved and would like the £200 cap on compensation extended;
9. network resilience is not a new phenomenon and companies should not be given additional allowances for activities they should have been undertaking anyway.
10. we support the development of a discretionary award for quality of supply provided it is focussed on activities that would otherwise fall outside of the incentive arrangements in the price control or Incentives and Information Programme (IIP);
11. openness, benefits to consumers and ease of implementation should be criteria for assessing projects under the Innovation Funding Initiative (IFI) and Registered Power Zone (RPZ) arrangements.
12. using a post-tax approach to the cost of capital will unnecessarily complicate the price control process, will not prevent the use of higher levels of gearing and will reduce comparability with other periods.

# energywatch's response to Ofgem's policy document

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### **1. Introduction – energywatch's Vision for DNOs**

Consumers already have important links with the DNOs. Distribution charges form 25% of the average domestic electricity bill and the inconvenience following a loss of supply can be significant. Although direct contact between a DNO and its consumers may be infrequent, such contact is usually about a high priority issue for the consumer, such as when will supply be restored, the operation of the Priority Services Register or the completion of connection works.

We have the following vision for the role played by DNOs:

*“Networks should be virtually invisible to consumers as they distribute electricity effectively, hitting enhanced guaranteed standards that reflect what consumers actually value and are willing to pay for.*

*They will have improved performance and reduced complaints about network activity. During severe weather events, DNOs would advise their customers effectively when power will be restored. For those unfortunate customers who are cut off compensation will be automatically payable.*

*DNOs would quickly reconfigure their networks to accommodate renewable generation as a result of the current price control at minimal cost that is hardly noticed by customers in general.”*

The price control is one of the key tools Ofgem has to influence the service that the DNOs give their consumers. As well as reviewing costs and revenues, the process needs to start by considering the quality of service that customers should expect and the redress that should be available should the standard of service slip.

Section 2 considers the implications of this vision for the price control framework. Section 3 provides our comments on the proposals made and issues raised in the policy document

## **2. The Implications for the Price Control Framework**

### **Trade-offs are needed**

Consumer interests are more sophisticated than merely wanting the lowest price.

Consumers acknowledge that trade-offs are required:

- on charges. These should be low, but sustainable. Deferring work on an asset may reduce costs, but a price control structure must not encourage the deferral of costs into the next period at the expense of the ongoing quality of supply
- on network security. Consumers can mitigate the risks from a loss of supply if they so desire, so the price control needs to encourage the development of networks to give a convenient, reliable supply, but without gold-plating.
- on network access. Capacity should be sufficient to meet demand, but consumers can make a contribution through demand management. The price control needs to encourage DNOs to look at all options, not just engineering ones.
- on communication. Consumers want readily available, accurate information from DNOs, but not at the cost of bankrupting a network.

The existing price control structure has managed these trade-offs and consumers have seen significant benefits as a result. However, the price control needs to keep pace with a changing environment and changing expectations. Consequently, we believe the following adjustments are needed.

### **An improving quality of service**

Overall, DNO service is good, but is not as good as it can get. The price control should anticipate that DNOs will deliver an improving quality of service on an ongoing basis. Numbers of interruptions will be minimal and outage durations will reduce. Communication will be accurate, timely and relevant. The environmental impact of the networks will diminish as it adapts to new requirements. The price control is a major input to achieving these outputs.

### **Balanced incentives**

One failing of the current arrangements is the differential treatment of opex and capex. A top priority should be to remove this difference, so that accounting policies are not a driver of company actions. Similarly, the arrangements should mean that a DNO is neutral to whether the electricity distributed is generated by plant connected to a distribution or transmission network.

Incentives need to be strong enough to encourage the capture of both cost and quality improvements by the companies. As consumers receive the full benefit of any quality of service improvements, the price control needs to encourage DNOs to invest to improve quality of supply and not just deliver the same standards for the same cost. This would suggest that a greater emphasis is placed on the IIP element of the control.

### **Reliable information**

The differences in the raw data provided by the DNOs highlights two issues. The primary concern is that the price control incentivises genuine improvements in performance, rather than informational game playing. New reference points, such as those proposed for the severe weather arrangements, need to be well defined and effectively monitored. We recognise that there are difficulties in providing accurate forecasts of capex for the later parts of the price control period, however the past

performance of the DNOs does not make us confident that such uncertainties can be left unscrutinised and unsanctionable until the next price control review process.

Secondly, there are significantly different assumptions being used across DNOs. This need not be an issue provided that the assumptions are clearly stated and justifiable and that, over time, the companies are seen to learn from events that challenge those assumptions.

### **Addressing new issues**

Since the last review process, network resilience and the development of distributed generation have gained importance. We acknowledge that meeting the Government's environmental targets will affect how DNOs provide economic, efficient and co-ordinated networks and support the thrust of the changes proposed in this area. New techniques and approaches will be needed, but we do not expect such changes to become a justification for consumers experiencing a poorer quality of supply. By contrast, other than developing the interim arrangements for severe weather compensation, network resilience should be seen a part of the standard service and not an extra obligation that warrants extra funding.

### **3. Responses to the Proposals Made and Issues Raised in the Policy Document**

#### **The Form, Structure and Scope of the Control**

##### **The revenue driver**

We support the retention of the broad form of existing revenue driver. However, the proposed EC Directive on Energy End-Use Efficiency and Energy Services includes a proposal to remove incentives on operators in monopoly segments to increase the volume of energy handled, so we urge Ofgem to investigate alternative revenue drivers early in the next price control period. We agree that it is appropriate to review weightings of various voltage categories; however we are concerned that this has not been raised before this time, as all parties need to be clear on the principles used.

##### **The scope of the control**

We repeat our previous comments that transmission exit charges should be within the scope of the control. Our view is based on two factors. Firstly, DNOs should be involved in defining the requirements of the assets involved and not just passively accepting NGC's plans, which is possible under a pass-through treatment. Secondly, DNOs should have equal incentives to distribute electricity from any source. Placing distributed generation within the price control scope and transmitted generation outside will inhibit the DNOs' willingness to handle distributed generation.

We support the proposed treatment of wheeled unit costs and revenues.

We agree that existing EHV-connected consumers should be given protection under the price control and support the proposal to include new EHV connections within scope of the control from the beginning of price control period following connection.

The purpose of this change is to widen the protection from the price control. Therefore, the principles used to create the existing basket weightings should be extended to cover EHV units in the revenue driver, unless this would establish a new cross-subsidy between EHV and other consumers. If this is the case and there need to be any changes to the principles themselves, these changes should be the subject of further consultation.

We support the development of a clear schedule of charges for non-contestable services and the extension of standards of performance to all new connections. Financial penalties should be attached to these standards as part of the IIP at the earliest opportunity, which would be once a clear benchmark is developed

##### **The treatment of out of area networks**

The difference between in and out of area networks primarily relates to the obligation to connect consumers. Once connected, a DNO's out of area network is still a monopoly and consumers need protection. The treatment of out of area networks must be consistent with their in-area networks, otherwise it may be possible to develop commercial structures develop to exploit any loophole.

##### **Losses**

We support the proposed treatment and simplified reporting of losses. We acknowledge that clusters of distributed generation could increase losses, so giving DNOs limited protection from this is acceptable in principle provided appropriate signals are being made to potential generators through charging structures. In these

cases, it would seem appropriate that the increase in losses is charged to the generators responsible for them.

### **Assessing costs**

The definitions of costs would not be such an issue if incentives could be equalised. However, we note that the companies have already shown which costs should be capitalised or otherwise through their previous behaviour. We therefore oppose the proposal to offer a depreciation adjustment for actions that some businesses felt were in their best interests anyway.

### **Linking capex and outputs**

The fact that the link between capex and outputs is not clear is not grounds for inaction, but should be grounds for further research so that future reviews can be better informed. In the meantime, we envisage that that IIP should be extended further, for example by including a specific element for the quality of supply improvements available from capex programmes. Another option could be to develop measures and incentives for unplanned outages net of those related to external events such as lightning strikes or storms.

### **Capex forecasts**

The wide range of capex forecasts illustrates the range of assumptions used in the forecasts submitted by the companies. However, the issue is not differences in forecasts, but differences in delivery. Consumers want reliable supplies and they need to be able to rely on companies actually doing what they say they will do. This means that the assumptions need to be transparent.

We acknowledge that later year forecasts are subject to much greater uncertainty than earlier ones. One way of dealing with this issue, which is used in long-term commercial contracts is that the control could include a range of capex costs for each year, which each DNO has to narrow as the delivery period gets closer. This process could also be used to validate previous year's figures and more closely scrutinise those companies with more wayward forecasts.

### **The metering price control**

The primary concern when setting the price control for metering is that it must facilitate effective competition in supply. We are concerned that metering could frustrate supply competition; for example, charge rebalancing could impact some suppliers more than others and make some market segments less attractive.

We support the use of a simple non-discrimination provision and oppose relying solely on a charging methodology approach – experience from the connections arena has shown the shortcomings of this approach

The definition of “basic metering” needs to be consistent with suppliers' obligations, but must also be forward looking, so that localised generation through, for example, domestic CHP or photovoltaic arrays does not face another barrier.

## **Quality of Service and Other Outputs**

### **Guaranteed standards**

We fully support the move to automatic payments for failing to restore supplies within 18 hours and the proposal for DNOs to contact consumers proactively to make them aware of their right to compensation when there has been a breach.

We are disappointed, however, that Ofgem do not believe LV-connected business customers are not entitled to equitable treatment when it comes to the level of compensation due. A typical business consumer uses more units and pays more for the service they receive, yet these proposals do not recognise this. We would urge Ofgem to reconsider this issue so that business and domestic consumers receive equivalent compensation relative to their charges and use of the network.

We also consider that these principles should be considered when assessing the level of compensation for HV-connected consumers. Willingness to pay is an appropriate parameter when considering improvements in quality of supply, but should not be the primary criterion when the failure to deliver a service is the heart of the issue. One multi-site consumer has experienced over 50 interruptions in each of the past two years and estimates that this has led to lost revenue of almost £800,000. These figures are not intended to form a case for compensation to include consequential loss. However, we urge Ofgem to amend the compensation regime so that it relates to the DUoS charge element paid by a business consumer.

We note that Ofgem consider the exiting suite of guaranteed standards provide sufficient incentives to DNOs to deliver good levels of consumer service. However, our complaint data shows that the levels of dissatisfaction are significantly greater than would be inferred from the number of guaranteed standards payments made, which suggests that there is a disconnect between the consumer experience and the companies' reports of that experience. We would welcome the opportunity to explore these differences further with Ofgem and the companies.

### **The IIP scheme**

We support the proposals to amend the IIP scheme by moving to annual rewards and penalties. Robust definitions are needed for the number and duration of interruptions and for determining the definition of worst served consumers.

The weighting for planned and unplanned interruptions needs more detailed consideration. Consumers require sufficient notice of a planned interruption and accurate information, for example about its duration, so that they can make appropriate arrangements.

Accuracy of data is critical to the success of the scheme. We favour an audit framework where all DNOs have to report the results of annual audits they carry out, supplemented by random audits by Ofgem on a small number of the companies. We also support the adjustment of performance data for any inaccuracies identified by the audits.

We fully support the inclusion of consumers who have their calls answered by an automated message in the telephony survey. At times of peak activity, this is the only experience consumers have of the service given by a DNO. Accuracy, timeliness and relevance are applicable criteria regardless of whether the information is provided directly by a person or through an automated system.

We support the principle of a discretionary award for examples of good performance in areas not directly covered by the IIP incentives. A key feature will be that it encourages companies to think more widely than the explicit measures and incentives, so that consumers receive good service at all times.

### **Network resilience and severe weather**

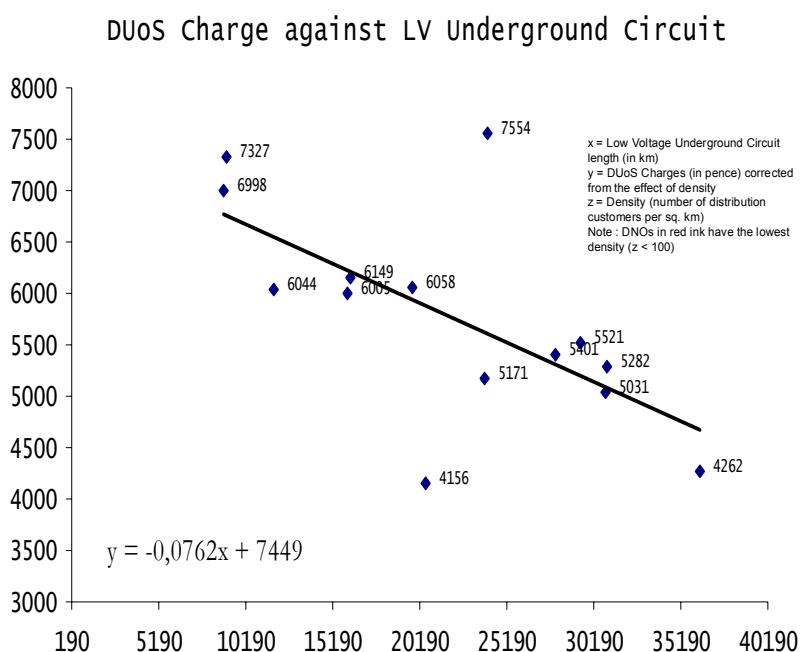
We support in principle the proposal to refine the interim arrangements covering severe weather, but need to see the definitions before we can fully support the



regime. We are not convinced, for example, that incentives for making payments proactively, coupled with a cost-pass through arrangement and definitions which are likely to require the DNOs to provide the input information is going to work in the best interests of consumers. Developing the resilience of the network to a variety of environmental conditions is a core part of the service provided by a DNO, so we believe that incentives in this area should be framed as penalties, rather than rewards.

## Undergrounding

The Accent survey indicated that consumers wish to see more cables placed underground, particularly in national parks and areas of outstanding natural beauty. We have also studied DNOs existing use of underground circuits and found that, after allowing for consumer density, lower DUoS charges are correlated with a greater use of underground circuits. This would suggest that there is a commercial, as well as environmental, benefit to be gained through greater undergrounding.



## Information about reliability of networks pre connection

We propose that there should provision for the DNOs to provide an information about the networks reliability before connection agreements are made. This issue is particularly important to large multi site users who might have thought differently about the choice of location if had they been better informed about the quality of supply in that particular location (as opposed to the network as a whole). Such a requirement would benefit consumer in the following ways-

1. The consumer is in a position to consider investment in back up supply or invest in other contingency measures.
2. The consumer could trade off between a low cost and a more secure connection agreement.
3. The consumer could ultimately choose to re locate

## Distributed Generation

### The distributed generation incentive scheme

We support the core elements of the hybrid incentive for distributed generation described in the document and the proposal to recover the incentive from those generators connecting to a network after 1 April 2005. The proposal to lock-in the incentive rate also appears acceptable.

We are concerned however about how the “stranded asset” arrangements will work, as once pass-through costs are recoverable from consumers, the incentive to find alternative generation to locate where there are appropriate assets in place is significantly diminished. The combination of these arrangements with the proposal to provide a floor to the return a DNO will obtain from its support of distributed generation, to be recovered through the charges levied on distributed generators, does not appear to strike the right balance of risk and reward between DNOs and consumers.

We are not convinced that providing a higher incentive rate for SSE-Hydro will be desirable, as it could deter generators from locating in this region when such decisions are marginal. In addition, the impact of such a move could be to increase the marginal cost of generation which could then affect all units generated, whether in SSE-Hydro’s area or not and whether renewable generation or not.

Microgeneration will be a contributor to the achievement of the government’s environmental targets and we support the inclusion of microgeneration within the incentive scheme. To exclude this group of fledgling technologies from the distributed generation incentive scheme is likely to reduce the willingness of DNOs to accommodate such capacity. We are also unconvinced that the implementation costs for the incentive scheme will be significantly different, as the DNOs will need to know what units are connected to what parts of their networks to be able to manage system flows effectively.

With regard to reporting arrangements, we hope that any administration will be minimised through linking the incentive scheme with the Renewables Obligation and Levy Exemption certification schemes.

### **The Innovation Funding Incentive and Registered Power Zones**

We support the proposals in principle for the Innovation Funding Incentive (IFI), but are concerned that there is not strong link between the allowance and delivering value to consumers. We acknowledge that an intrinsic factor of research and development is that some projects do not deliver the anticipated results, but our concern is that the information gained from all projects is widely available. IFI funding should, therefore, not be available for projects that do not agree to the open reporting of their findings.

We support the desire for interim arrangements that could start in advance of the next price control period. This could be managed by including a pro rata allowance on a use it or lose it basis and reporting the outputs in the arrangements for 2005/6.

We broadly support the defining criteria for a Registered Power Zone<sup>1</sup>, provided the innovation relates to the network connection, or the subsequent operation of the network, rather than to the generation technology itself. This may be the adoption of an entirely new technology or the novel application of an existing technology. In the case of innovations in network operation we would expect the area involved to be clearly defined and justified by the DNO. Where quality of supply might be affected, we would expect any project to be regularly reviewed within each year so that any

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<sup>1</sup> These are understood to be set out in paragraph a) of the table on p67 of the document

deterioration in performance can be identified and the project terminated if acceptable performance is not justifiably anticipated. If consumers suffer as a result of an RPZ project not meeting its design objectives in full or in part, we would expect the DNO to compensate consumers as part of the risks being borne.

We strongly support the development of an industry wide good practice guide. The cross-fertilisation of ideas and techniques is one of the benefits of the scheme. We anticipate that this would include the consideration of new techniques into ongoing network design and development.

## **Financial Issues**

### **The regulatory ring-fence**

We support the strengthening of the financial ring-fence and the need for prior consent, if a credit rating deteriorates significantly, before certain transactions are undertaken. We are concerned, however, that as the trigger level proposed is when minimum investment grade rating is under threat, the trigger may not be enforceable in time. We believe that any consent for transactions needs to be public, so that all concerned parties can be aware of the DNO's situation.

### **The cost of capital**

We do not support the proposal to use a post-tax approach to the cost of capital for two reasons. Firstly, including specific estimates of tax costs will make the price control calculations more opaque. If Ofgem were able to get perfect information from the companies and there were no uncertainty in the regime, then Ofgem may be able to make a realistic assessment of tax costs as an explicit element of the price control. However, the range of assumptions used by different companies, difficulties over normalising costs, the treatment of fault costs and the inherent uncertainty in forecasting capex programmes in the later years of the control illustrate that these conditions cannot be achieved. The consequence of using a post-tax approach will be to heap taxation estimates on top of cost estimates, so compounding uncertainties in the price control outcome.

Secondly, the process of determining specific estimates will require the establishment of a reference point for the level of gearing. Once known, the companies will still have an incentive to move to higher gearing levels as this is inherent within the tax regime and independent of the composition of the price control.

We do not object to Ofgem publishing their estimates of the post-tax cost of capital, however to maintain clarity and enable comparisons over time, we believe it is essential that the pre-tax cost of capital is retained as the primary reference point.