

# Electricity Distribution Price Control Review



## Response to Regulatory Impact Assessments (RIAs):

### RIA for the Price Control Review

**APPENDIX 1: Response to RIA for Distributed Generation and Structure of Distribution Charges**

**APPENDIX 2: Response to RIA for Registered Power Zones and the Innovation Funding Incentive**

**APPENDIX 3: Response to RIA for Metering**

**APPENDIX 4: Response to RIA for Quality of Service**

**05 May 2004**

**CONTENTS**

<b>1</b>	<b><i>Executive Summary.....</i></b>	<b>3</b>
<b>2</b>	<b><i>Overview on RIAs.....</i></b>	<b>4</b>
<b>3</b>	<b><i>Appendix 1: Response to RIA for Distributed Generation and Structure of Distribution Charges.....</i></b>	<b>6</b>
<b>4</b>	<b><i>Appendix 2: Response to RIA for Registered Power Zones and the Innovation Funding Incentive.....</i></b>	<b>10</b>
<b>5</b>	<b><i>Appendix 3: Response to RIA for Metering.....</i></b>	<b>11</b>
<b>6</b>	<b><i>Appendix 4: Response to RIA for Quality of Service.....</i></b>	<b>14</b>

# 1 Executive Summary

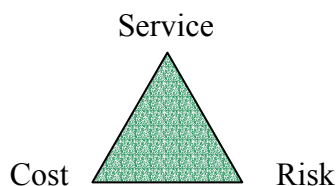
- We welcome the use of RIAs and think that they are important.
- We would expect to see clearer recognition of the wider government agenda and impact on society reflected in Ofgem's RIAs and analysis.
- We therefore see a real need for Ofgem to take into account wider environmental objectives and sustainability.
- A more rounded approach to the RIA would be to first set out the cost benefit for the UK as a whole (arguably a proxy for the long-term interests of customers), before considering the effects on individual stakeholders.
- The impact of any proposals need to be described in terms of cost (price), service and risk
- The RIA for the overall price control review should explicitly examine the regulatory impact on the DNOs as well as on customers.
- It is recognised that Ofgem's statutory duties are relevant considerations in terms of the background to proposals and Ofgem's own priorities, they are not however justification for proposals for which the regulatory impact is not positive or is questionable.
- We would expect to see drafts of the overall RIA for the entire price review well before the final proposals – preferably with a first draft in June, to accompany the initial proposals.

## 2 Overview on RIAs

We are pleased to see that Ofgem are putting increasing efforts into the development of Regulatory Impact Assessments (RIA). We welcome the requirements of the Sustainable Energy Act which puts a broader obligation on Ofgem to justify their policy proposals in terms of the likely effect on the whole economy. This should encourage a different kind of debate from that which typically characterises Ofgem policy consultations, where Ofgem can legitimately represent customers' interests, and companies respond on behalf of shareholders. An RIA needs to take a more balanced and objective view of the overall effect of any proposals.

It is helpful to consider the four draft papers published by Ofgem in March, as they represent different stages of work in progress on an RIA. Whilst we see merit in developing these assessments in isolation, where an area of policy can be considered on its own, we also believe that it will be necessary to consider the interaction between policies. The work to date is likely therefore only to be a step towards an integrated review of the price control review proposals. At this point the interaction between policies and incentives must be considered, and an overall view of the likely effects and intended benefits of the package of changes should be presented.

When we consider policy options, we usually seek to review the potentially competing effects on three dimensions of our business: service, cost and risk. These measures can be seen as points of a triangle:



It is unusual to be able to improve against all three dimensions at the same time, and what is more often needed is to recognise the trade-offs between them in order to identify an optimal approach. We would expect an RIA to make comparable assessments, but take into account the interests of all stakeholders. In this way it would go beyond a cross-check against Ofgem's statutory duties. One role of the RIA should be to identify the potential for those duties to act against other possible policy objectives. This can be seen most clearly in the discussion on the assessment of Ofgem's policies in respect of the connection of distributed generation, where DNO efficiency is given substantially more weight than the delivery of Government environmental targets.

Attached to this note are more detailed comments on the four papers prepared by Ofgem on specific policy proposals. We have tried to review them in the context of the Sustainable Energy Act and the guidelines produced by the Cabinet Office for producing RIA. The table below offers a simple checklist against the section headings proposed by the Cabinet Office. Whilst not a complete measure of compliance, it could be a helpful initial guide to the state of progress.

	<b>DG &amp; SoC</b>	<b>RPZ &amp; IFI</b>	<b>Metering</b>	<b>QoS</b>
Effects	✓	✓	✓	✓
Options	✓	✓	✓	✓
Benefits	✓	✓	✗	✗
Costs	✓	✓	✗	✗
Consultation with small businesses	✗	✓	✗	✓
Enforcement	✗	✗	✗	✗
Monitoring	✓	✗	✓	✗
Consultation	✓	✗	✓	✗
Competition Impact	✓	✗	✗	✗
Impact on consumers	✓	✗	✗	✗
Risks and unintended consequences	✓	✓	✗	✓
Distributional impact	✗	✓	✓	✓
Environmental impact	✗	✗	✓	✗
Security of supply	✗	✗	✓	✗
Summary	✓	✓	✓	✓

We understand that Ofgem intend to consult more generally on the approach to Regulatory Impact Assessment. We look forward to participating in discussions on this subject over the coming months. However, we believe it is important that the overall impact of the Distribution Price Control Review is assessed within the life of the project. Ideally there should be a draft assessment available with the Initial Proposals in June and a more complete assessment to accompany the Final Proposals in November.

These papers should bring together the various strands of Ofgem's work and set out the likely impact on customers, companies and other stakeholders. In particular, there should be an evaluation of the impact against the policy objectives set out in the Energy White Paper. These also have the potential for conflict and the RIA should assist in a broader understanding of how priorities have been determined, and what alternative outcome might result from a different balance of policies. Obvious examples would be the balance between more reliable electricity supplies, an increasing focus on low carbon sources of energy and the desire for affordable prices. The Price Control Review is the opportunity to consider both the balance between cost and service quality / risk (Value for Money) and the absolute level of services that should be delivered by DNO's in the years to 2010 and beyond. A thorough Regulatory Impact Assessment would support public debate on these issues in a way that should complement the detailed, and more technical, discussions encouraged by Ofgem's policy consultations.

### **3 Appendix 1: Response to RIA for Distributed Generation and Structure of Distribution Charges**

#### **3.1 Objectives and key issues for these policies**

We are concerned that Ofgem does not believe it has the statutory powers to help overcome barriers to DG connection in ways that have a direct cost effect on demand customers – i.e. Ofgem does not consider it has a mandate to implement government policy by helping generation at the expense of consumers. We remain most concerned that this approach is in itself a potential barrier to DG growth.

The DG and Structure of Charges policies have the following stated objectives:

- To remove barriers in the connection and use of distribution systems
- Provide appropriate incentives for DNOs to connect and utilise DG in an economic, efficient and co-ordinated way, including responding in a positive and proactive way to connection requests

Implicit in the first of these objectives is a recognition that it is desirable to facilitate and therefore increase the number of Distributed Generation, especially renewable and CHP, connections. The development of renewables is already enshrined in government policy and does not need to be further justified here. What we would expect the document to set out is an assessment of the incremental costs and benefits to the key stakeholders, drawn as widely and as long-term as is appropriate for the overall policy objective, and then demonstration that the suggested framework can achieve its aims, or at least play its part in the overall objective.

The second of the key issues, identified in 2.6, can be taken to be a reference to deep charging. Our main concerns are that the case against deep charging and the proposed design and size of incentives are not adequately argued.

Deep charging does allow DNOs to develop efficient networks, although certainly there needs to be processes in place to deal with large strategic reinforcements that will benefit many potential customers. In fact, we believe special treatment of strategic reinforcements will always be necessary, even under Ofgem's proposed incentive regime for DG, and we have made this point in our response to the March 2004 policy document.

This RIA almost acknowledges this point when in 2.6 it states that DNO charges historically have been cited as being a barrier to entry. The second bullet of 2.6 says that charges should fall on who causes them – which is exactly what current DNO charging does. We are concerned that pursuing this economic principle is actually damaging the Government's wider environmental policies by placing even higher, and more volatile, charges (i.e. for all shared infrastructure as well as that required to facilitate the connection) onto DG projects than the existing arrangements do.

## **3.2 Options**

We are concerned that Ofgem appears to be confusing the use of incentives. In particular, 2.10 only deals with the incentive to be efficient, whereas DNOs also need an incentive to change behaviour. To say that other options, such as a revenue driver alone, have been rejected is a little disingenuous – they have only been rejected by Ofgem in Ofgem’s own papers as far as we are aware.

We disagree with the points made against DG incentives with deep connection charges in 2.10. Firstly, an incentive does not need to be associated with partial pass through of costs. We agree that the latter provides an incentive for cost efficiency but do not accept that it is an essential element of a driver towards achieving a desired change in behaviour.

Furthermore, we do not believe that it would be inconsistent with Ofgem’s statutory objectives if the incentive payment were made, at least in part, by demand customers. We base this comment on the assessment of the impact on customers, set out below.

## **3.3 Views of interested parties**

In 2.13 we would wish to underline again our belief that the RIA needs to consider the wider social and environmental aspects.

In 2.14 we are concerned that the potential for distortion of the generation marketplace attendant on significant changes to charging regimes is not really addressed in the RIA even though you specifically mention our previous concerns in this section. And whilst looking at our previous comments, we still do not see how moving the deep charging boundary towards the point of common coupling which is the current contestable charging boundary has any effect at all on competition in connections.

## **3.4 Impact on Distributed Generators**

2.17. We disagree that the proposal provides the benefit. The free rider problem is already fixed. Second, deep charging is the simplest way of ensuring that generators pick up their incremental costs. Ofgem’s proposed approach exposes DG to sharing the costs of existing infrastructure.

We believe that the first-comer/second-comer issue raised in 2.17 is not an issue that is driving change, given the recent introduction of the Connection Charges Regulations. These have effectively ended this problem already, albeit that this alone does not overcome the problems alluded to above whereby large strategic investments will need a different treatment.

This point requires more consideration. We are aware that strategic reinforcements in Transmission in Scotland appear to be being treated on an “identification and ex-ante” treatment. We are puzzled as to why Ofgem do not believe that a similar approach is needed for the 132kV system in England and Wales. Without such a treatment DNOs

are most unlikely to invest, as generators will not be able to fund them, either under existing deep reinforcement charging, or under the proposed incentive arrangement. Although the RIA is silent here, the detailed proposals in the March DPCR update in effect put all the costs of the strategic reinforcement onto the one generator that precipitates the reinforcement, if the cost of the reinforcement is greater than £200/kW, thereby reverting to deep charging for that generator.

2.19 and 2.20. We do agree with your calculations. They show that 6% reduction in costs (i.e. bringing the average to £47/kW) would make the incentive self-financing.

2.21 and 2.22. We generally agree with these sections, but we are most concerned that the approach does not work for large strategic investments – as stated above.

Ofgem asserts that these arrangements should encourage a higher volume of generation capacity being connected. Section 2.22 then goes on to say that the other factors listed are likely to be more important in driving the level of DG. This calls into question the sufficiency of Ofgem's approach to barrier removal and incentivisation, or at least raises the question as to whether Ofgem should be trying to design incentives that are commensurate with these other issues.

Ofgem's proposals generally increase project costs for generators, by the amount of the incentive, and make their payments potentially volatile year on year. In debate at a recent ISG meeting, generator representatives were horrified at the potential volatility in GDUoS indicated by initial DNO work. We agree that the prospect of the incentive might have a downward pressure on DNO costs, but that is against a background of rising infrastructure costs (as evinced by the DNOs' DG BPQs).

### **3.5 Impact on Customers**

We note that 2.23, 2.26 and 2.28 all argue that the net effect on customers is minimal: we agree with this and therefore believe that there is scope for Ofgem to take more effective steps in encouraging DG growth.

In 2.29 Ofgem suggest that an extra 500MW of DG can be conservatively assessed as having an environmental value of £5M per annum, i.e. £10/kW pa.

The £/kW element paid to DNOs needs to be set to recover the costs not passed through directly to GDUoS and also an incentive element to give a return above the cost of capital. Using the proposed parameter of 1% above WACC and an estimated average cost of £50/kW, the incentive element is calculated (in Ofgem's Table 2.1) to be £0.35/kW pa.

Assuming (as in 2.29) that only 5% of the new DG connecting can be attributed to the incentive scheme, this suggests that the environmental benefits are sufficient to fund, or at least justify, the entire incentive element as calculated above. This calculation disregards the downward pressure on costs that the incentive scheme is designed to bring, which would justify a higher level of incentive. Ofgem calculate (2.20) that 6% reduction in costs (i.e. bringing the average to £47/kW) would make the incentive self-financing and we concur with this calculation.



A further comparison can be made with the £92/kW pa payable to a renewable generator under the ROCs scheme (para 2.20).

### **3.6 Impact on DNOs**

We note that there is no mention of the effect of risk on DNOs. As we have continually maintained, a 1% premium is not sufficient to allow discretionary investment, or to support the volume risk attendant on strategic investments. We are also disappointed that there is no mention of the cash-flow risk attendant upon the proposed arrangements.

We note that there is no mention of funding of the implementation costs. We expect these to be explicitly allowed in the price control.

We also take issue with the first bullet of 2.30. Whilst true as far as it goes, we believe that the RIA should demonstrate that the higher rate of return is in fact high enough to change behaviour. On this point, to encourage the desired behaviour, we believe that the incentive rate should be maintained for the (assumed) life of any new assets that have been installed to connect generation (helping to reduce DNO risk and GDUoS volatility) and also that system changes such as referred to in 2.31 are specifically allowed in the price control review.

### **3.7 Risks and unintended consequences**

In 2.33 we are pleased to note that Ofgem recognises that consumers already bear the risk of annualised connection charges for generators.

Also in 2.33 it is stated that any shortfall in GDUoS income derived, under certain circumstances, could be recovered from demand customers. We agree with this: it is an almost unmeasurable small amount per consumer. This still, for us, leaves open the real opportunity for Ofgem to bolster the Government's renewables policy by adding a direct cost to consumers.

### **3.8 Conclusion**

In summary, we are not persuaded by several aspects of the RIA. In particular:

- The RIA does not address the wider policy issues;
- The RIA does not justify Ofgem's view of its statutory duties vis-à-vis consumers;
- The RIA fails to analyse how the proposed incentive scheme will bring forward necessary strategic investment.

## **4 Appendix 2: Response to RIA for Registered Power Zones and the Innovation Funding Incentive**

This appears to be the most well-developed of the RIA and presents a sound case for the proposed approach.

We welcome the recognition that there are many other aspects of efficient DNO operation that will benefit from innovation, rather than just DG, and particularly welcome the inclusion of all DNO RD&D activities within the scope of the IFI.

We welcome the recognition that innovation includes the putting into effect of ideas that are not new, but have either had limited or ineffective application in the past. We are particularly pleased that the approaches to network problems, listed in Appendix 2 of the RIA, are all included for potential IFI and RPZ funding, given that most of the ideas are not innovative, but their application is genuinely so.

### **4.1 The transition to active systems**

We are not as certain as Ofgem appear to be in Section 2.23 of the RIA that active distribution networks will turn out to be the most cost-effective way of managing DG. This will depend on many as yet unknown factors. But we do agree that DNOs need to engage in appropriate R&D to determine what are the optimal solutions for future DG mixes. In particular we are not yet convinced that DNO systems can ever be classed as a mini transmission system, given the differences in power system effects (such as R/X ratios and VAr flows) at distribution voltages cf transmission voltages.

### **4.2 Views of other parties**

On an important point of detail, we do not recognise that 2.28 is an accurate depiction of our purchasing approach. For many years we have always purchased system equipment on the basis of whole life costs. The operational costs to us of equipment are not always known to manufacturers, and we would not necessarily discuss our detailed whole life modelling with manufacturers. Although we are keen to correct the misconception that we do not consider whole life asset management, that does not detract from other aspects of their view that there is a need for closer R&D work between manufacturers and DNOs to continue to deliver optimum asset management.

### **4.3 IFI – Costs allowed ex-ante and ring-fenced**

We agree that the ring-fenced ex-ante treatment for IFI funds seems the most appropriate.

## **5 Appendix 3: Response to RIA for Metering**

### **5.1 Objectives and key issues**

Ofgem's statutory objective to ensure the DNO is able to finance its functions is relevant to its work on metering given DNO's past, and potentially future, licence obligations to provide metering services.

It would be helpful to spell out more clearly what is the decision that is being subject to the RIA. It is not the policy of introducing competition in metering but the integrated suite of proposals for the treatment of metering under DPCR4. At a high level this encompasses the decision to split the current integrated distribution control and the basis upon which costs are allocated between metering and the rest of distribution. It then covers the decisions on regulating the prices of metering services provided by the DNOs (currently listed under the options section) and extends to the related decision on maintaining the licence obligations.

### **5.2 Options**

The proposals for metering involve a number of decisions, which potentially create a wide range of possible options upon which cost / benefit analysis should be conducted. However, it is obviously not efficient to seek to undertake such analysis on too great a number of options, so it would seem appropriate that work should focus on those options advocated by industry participants – Ofgem, DNOs, suppliers and new entrants.

### **5.3 Risk and unintended consequences**

If the allocation of costs to the DNO metering activity is set too high then there is a risk of inefficient stranding of the assets, systems and people associated with the provision of these services. The regulatory framework does not permit the regulated DNO metering business to bid for competitive metering contracts. In addition, the nature of the historic obligations on this business (e.g. ESPS) causes them to be uncompetitive. Any DNO that wishes to enter the competitive metering market will do so through companies outside of the regulated DNO as can be seen from the market developments to date (Meterfit, Onstream, MSL etc).

There is very limited potential for regulated DNO metering resources to be redeployed on competitive contracts for the reasons outlined above and the geographically constrained area of operation compared to the national contracts likely to be offered by suppliers.

If the allocation of costs to metering is too low then there is a risk this will deter new entrants to the competitive metering market.

Where the fixed costs of the DNO metering activity are allocated to the metering price control this will result in significantly increasing unit charges to those suppliers.

If the outcome of DPCR 4 results in significant stranded costs for the DNOs this will increase the market perception of regulatory risk with unintended consequences for the wider regulatory environment.

## **5.4 Competition**

The key feature of competition in the domestic metering market is that it is supplier driven. The 6 large suppliers control 95% of the work volumes. Five of these suppliers have metering businesses within the same corporate group. The only supplier (BGT) that does not have a metering business is the only supplier to date that has entered the competitive market. There is a risk therefore that competition will not develop because suppliers place contracts with in-house operators.

Whilst price is an important factor in the decision to enter the competitive market there are specific benefits to suppliers in rationalising the number of agents they appoint, using the same agent for gas and electricity, standardising on IT interfaces and putting in place specific service standards for their customers. The ability of suppliers to take advantage of these benefits is constrained by the extent to which their own systems are able to be adapted. A number of the suppliers who have grown rapidly through acquisition may wish to complete integration before pursuing these benefits.

The continued presence in the market of DNOs with licence obligations and regulated prices will influence the development of competition. A key feature in developing competition will be the structured exit of DNOs from metering activities. Their presence permits continuation of the “status quo” as an option for suppliers with priorities elsewhere.

## **5.5 Costs and Benefits**

In the section above we have indicated some non-price benefits that may arise. There will be some price benefit for those suppliers that move into the competitive market as a new entrant is not faced with the historic costs associated with the DNO metering activities.

In addition, there is some benefit in having a single provider of gas and electricity metering. Quantification of the benefit needs further research.

Based on the latest information on the intentions of the two largest suppliers in the UU region, we estimate that UU will be facing substantial restructuring costs in the near future. In addition there is a need to agree funding of the last resort service which could cost in the region of £3m per annum.

DNO metering activities will suffer diseconomies of scale as fixed costs are recovered over reduced work volumes. In addition, the requirement to provide full geographic cover and maintain existing service standards results in a non-linear reduction in resources, again creating diseconomies of scale.

## **5.6 Environmental Impacts**

We agree there is little environmental impact of these proposals.

## **5.7 Distributional impacts including social impacts**

Prepayment meters are five times more expensive to buy and have half the certification life of standard single rate credit meters in the case of UU. The majority of visits for reasons other than statutory meter change are to premises with prepayment meters either being installed/removed or customer service calls to prepayment meter customers. It is our belief the cap is currently constraining the full costs of prepayment metering being reflected in DNO charges.

If the cap is removed then prepayment charges will rise and this may have a social impact should suppliers choose to pass this cost onto the customer. However, if the cap is retained this may lead to suppliers leaving prepayment metering with the DNO (as it is effectively cross subsidised) and cherrypicking the credit metering. The only way a cap could work effectively with a split price control is to recover the additional costs of prepayment metering through DUoS charges.

## **5.8 Security of Supply**

We agree there are no direct security of supply implications.

## **5.9 Summary of Costs and Benefits**

Further work is required to identify the potential options before the cost/benefit analysis can be undertaken.

## **6 Appendix 4: Response to RIA for Quality of Service**

This short appendix to the March consultation paper is a helpful indicator of Ofgem's initial thought process.

Whilst we can see the purpose of all of the questions posed and agree that they need to be answered, we are concerned that there is no evidence of deeper thought about the context within which the Quality of Service incentive arrangements are being developed. There is no examination of the broader public policy agenda. What evidence is there of Government (national or European) views on either service levels or incentive frameworks. We would expect to see reference to the Energy White Paper and the recent Trade and Industry Select Committee report as a minimum.

It is also difficult to see quality of service in isolation from other aspects of the price control review. In particular there is a clear interaction with costs and prices and a potential conflict with the developing work on incentives. Furthermore, there is little acknowledgement of the importance of risk in any assessment of service quality. This is particularly important in areas such as quality of supply where there are no absolute linkages between performance and cost. Investment in assets or systems / procedures tend to reduce the risk of service failure or mitigate its effect, but cannot prevent all interruptions. Consequently the assessment of potential impact needs to be seen in probability of failure, and this must also affect the nature of any incentives that are planned.

We recognise the importance of rapid progress in this area, since discussions will be needed on the quality of service incentives for the next price control period as part of Initial Proposals. We understand that you were not expecting your questions to be answered at this stage. Indeed many depend, at least in part, on the results of the customer survey due shortly. However, we are ready and willing to contribute to the development of your thinking in this area, either through formal consultations, or informal discussion.