Electricity Distribution Price Control Review – Initial proposals – June 2004

A Response by British Gas Trading

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EXECUTIVE SUMMARY

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

Generally we welcome Ofgem's initial proposals for the next five year electricity distribution price control which is due to take place from April 2005. With inflationary pressure on customer bills from rising commodity prices potentially leading to an increase in fuel poverty, the reduction of distribution prices is to be welcomed.

In particular, we welcome Ofgem's proposals to include EHV within the price control and to equalise opex and capex incentives to reduce the scope for gaming though we do not welcome a reduction in the overall incentives by reducing opex incentives to the levels of capex.

We are disappointed that Ofgem did not take this opportunity to revise its approach to areas of the price control where shortcomings were identified at DPCR3 and during the DPCR4 consultation process. In our written responses and at follow-up meetings with Ofgem's price control team, we have argued for a far greater refinement of the price control mechanism and the opportunity to deliver a fairer deal to consumers and network operators. We are particularly disappointed that Ofgem has not adopted our proposals for the treatment of losses and connections. With respect to connections, we would urge Ofgem to consider incorporating them within the main RPI-X price control during DPC4 if competition does not develop at a rapid pace during the next couple of years.

Losses

- We remain concerned that DNOs will be paid twice for reducing the theft element of losses via the units driver as well as the losses incentive.
- The capital expenditure eligibility test should be tighter to reflect the overall losses valuation.
- It is inappropriate to proceed with the asymmetrical DG protection.

Metering

We have reviewed the indicative ranges outlined in Table 3.3 with our commercial meter operators and believe the charges to be significantly too low. We are also concerned that, at this late stage in the consultation process, the controls for meter operation are far from developed. We are also concerned that Ofgem does not appear willing to consult further on its initial controls for meter operation prior to the publication of the Final Proposals in November. We seek confirmation that, in keeping with due process, Ofgem will allow interested parties the opportunity to put forward their views in advance of any final decisions.

DPC3 capex incentive scheme

- An unwarranted windfall for DPC3 out-performance for those DNOs with accelerated depreciation appears to be intact.

Quality of service and other outputs

- The proposed revenue exposure levels appear reasonable, especially the increased incentives on the Interruption incentive scheme and Storm compensation.

- We welcome Ofgem's confirmation of DNO revenue reduction irrespective of compensation to affected customers.
- Ofgem should reconsider the intention to maintain the existing arrangements for HV connected business customers.
- Whilst we support the increase in CI and CML incentives/exposure, ideally we would have liked the scheme to be extended to volume of energy unsupplied.
- It is not possible to adequately comment on the appropriateness of the proposed CI/CML benchmarks as Ofgem has not published enough information on the performance that makes up the benchmarks.
- It would have been better to use trend rather than average performance over a number of years to set the benchmarks.
- We do not support the asymmetrical proposals of rewarding DPC3 frontier performers while poorly performing companies are not being penalized.
- We welcome the proposed Storm arrangements. These changes if implemented are likely to address our main concerns about the 'interim arrangements'.

Cost assessment

- Ofgem should set opex costs on the basis of the base regressions
- We fully support the Ofgem intention and rationale not to provide a glide-path or partial catch-up for companies not achieving upper quartile opex costs
- The detail of CEPA's report, rather than its conclusions, would imply that X for opex should be set no lower than 4% per annum
- We urge a greater degree of transparency about the setting of capex allowances to allow non-DNOs to scrutinize this significant element of expenditure

Presentation

We found Ofgem's presentation of the Initial Proposals disappointing and in places misleading. This made the assessment of the true P0 and Xs, hence overall charges that Suppliers are likely to face in DPC4, compared with those under the current price control, particularly difficult. The two price controls have materially changed in scope with:

- DPCR3
  - combined price control for metering and distribution
  - EHV connections excluded
- DPCR4
  - two price controls; one for distribution (referred to in executive summary of Initial Proposals) and one for metering (as yet only partially developed)
  - EHV connections included in distribution price control.

Additionally, DNOs are likely to receive increased revenues as a consequence of the DPC3 opex and capex out-performance incentive regime.

We suggest that in Ofgem's next publication it includes an upfront 'like for like' comparison table of how charges actually vary with metering added back into the control, EHV excluded and estimates of other DPC3 incentive schemes. We also suggest that Ofgem refers to the recent Ofwat Draft Proposals (Table 4) which clearly outlines the individual cost components that comprise customers' bills and how these impact on the change from one control to the next.

GENERAL COMMENTS

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

DETAILED COMMENTS

3. Form, Structure and Scope of the price controls

Form of the price control

Revenue driver

3.15 *"Ofgem proposes that for the next price control period there will be no volume driver attached to EHV revenues."*

We accept the logic of not including a revenue driver for existing EHV connections as the "majority of costs associated … are sunk in the initial connection cost" and "costs incurred by a DNO … are not driven by changes in the amount of EHV units distributed or capacity".

We welcome the inclusion of existing EHV connection costs within the main control as we understand that this will result in the operation of the RPI-X incentives on those. However we remain disappointed that the key element of EHV charges that are controllable, i.e. future EHV connections, will remain outside of the main control until 2010.

<u>Other issues</u>

We remain concerned that DNOs will be paid twice for reducing the theft element of losses via the units driver and the losses incentive. If DNOs could estimate the proportion of losses that are accounted for by theft as (opposed to other losses), an adjustment could be made to the overall incentive received by DNOs to ensure they were not paid for theft reduction twice. Though DNOs do not appear to be able to produce this estimate at present, they may not have an incentive to do so. Perhaps an appropriate incentive could be provided for the provision of reasonable estimates by inclusion in the "Discretionary reward" discussed at paragraph 4.84. This change may allow for the distortion to be resolved in time for DPCR5.

Scope of the price control

Price index

3.10 *"Ofgem proposes to use RPI for the next price control period."*

In line with our previous response, we welcome this approach.

Units distributed out of area

3.14 *"Ofgem proposes to impose a similar requirement on DNOs with respect of units distributed out of area as will apply to Independent Distribution Network Operators (IDNOs). Under these arrangements, IDNOs will not be able to charge domestic consumers any more than the incumbent network operator. Any revenue associated with distributing units out of area will be treated as an excluded service item."*

In line with our previous response, we welcome this approach. We also welcome the recent publication of Ofgem's consultation on regulation of IDNOs[1], in particular that it will also consider the enduring form of regulation for DNO units distributed out of area. However, if that consultation results in DNO charging arrangements different to those described in the DPCR4 Initial Proposals, then the new arrangements would amount to an effective change to the price control even though the revenue may still be treated as Excluded Services revenue. The possibility of such a change to the DNO's price controls should be signalled as part of the existing DPCR4 consultation process in order to avoid any potential DNO concerns about amending an agreed DPCR4 settlement.

Non-contestable connection charges

3.15

We reiterate our disappointment that customers will not be adequately protected as a consequence of not bringing contestable and non-contestable connection charges within the scope of the price controls until such time as competition is established.

Business rates

3.16

We are disappointed with Ofgem's proposal to allow effective pass through of business rates, as we believe that DNOs should be incentivised to ensure costs are at an appropriately efficient level. We understand that in Table 6.4 Ofgem has set out the network rates payable by DNOs over the DPCR4 period and that these have been based on the latest Rateable Value and Ofgem's latest views, i.e. forecasts. Ex ante allowances may vary from outturn costs and therefore suggest that if Ofgem is to adopt cost pass through of business rates, it introduces a formal pass through mechanism to adjust to outturn.

Hydro-benefit

3.18

To allow suppliers to estimate the likely level of charges in the Scottish Hydro area in advance of publication of the government's detailed proposals later this year, Ofgem should consider publishing an additional set of indicative proposals for Scottish Hydro that include an assumed level of Hydro subsidy. During the progress of the Energy Bill, the government indicated that the new transmission levy would be of a similar size to the previous Hydro benefit. This would imply that the previous level of Hydro benefit could be increased by RPI to give indicative proposals.

Revenue protection

3.19

DNOs are currently incentivised to find additional units of energy, i.e. offer revenue protection services, via the units distributed revenue driver and the separate losses incentive scheme. Any move to treat revenue protection as an excluded service will need to take account of these existing interactions.

[1] Regulation of Independent Electricity Distribution Network Operators – Consultation Paper – July 2004

Incentive framework

Retention period for efficiency savings

3.25

It is disappointing that Ofgem has not been able to devise sufficiently robust definitions of opex versus capex as Ofgem set this as an objective for DPCR4 at the conclusion of DPCR3. However, we recognize that even if reasonably robust definitions had been established, so long as there were higher incentives on opex, DNOs would have been inappropriately incentivised to substitute (rather than reclassify) capex for opex in search of greater out-performance incentives, rather than seek the most efficient outcome. In any event, no matter how robust the definitions of opex and capex, they are unlikely to be perfect. Consequently we have long argued for an equalization of opex and capex incentives and that aspect of Ofgem's proposals is to be welcomed.

However, at the very least, we would have expected average/overall out-performance incentive rates to be no lower than under DPC3. Consequently, we remain disappointed with Ofgem's proposals to reduce opex out-performance incentive rates to those of capex under DPC3. We would urge Ofgem to consider increasing the capex incentive rates so that the overall effect will be neutral to DNO incentives.

3.27

For the reasons noted above, we do not support moving to differential incentive rates part way through DPC4, though we support higher overall incentives than Ofgem's proposals. However, work should continue on better opex and capex definitions to allow improved benchmarking of opex and capex costs at DPCR5.

<u>Other issues</u>

We understand that the Ofgem model that implements the 5-year rolling capex incentive framework has been amended to exclude the potential unwarranted windfalls that would have flowed to DNOs from providing 5 years return and depreciation. However, it is our understanding that another unwarranted windfall for DPC3 out-performance, as noted in our previous responses, for those DNOs with accelerated depreciation in DPC3 appears to be intact. We would urge Ofgem action on this.

Losses

<u>Valuing the incentive rate</u>

3.37

We agree with the four components of valuing the incentive rate as described by Ofgem.

Costs of purchasing electricity

3.39

The forward curve is a sensible basis for estimating the costs of purchasing electricity. However, it appears that Ofgem has only used electricity 'baseload' prices; if that is the case then the Ofgem estimate will underestimate the real cost of supplier energy purchase costs. Electricity purchase costs are the sum of the relevant proportion of 'baseload' and higher priced 'peak' energy. Baseload at about £27/MWh might be expected to give peak prices energy at about £35/MWh. For illustrative purposes only, if 70% of lost energy is baseload and 30% is peak, then the total energy price is about £30.5/MWh. The actual proportion of baseload to peak used in the calculation should ideally be based on the shape of the energy lost demand curve as losses energy is more peaky than overall DNO demand. However, if it is not possible to estimate the lost energy demand curve, then the demand curve for overall DNO demand should be used.

The environmental cost of losses

3.40

Using a forward price curve to 2007 would mean that the cost of upstream environmental restrictions and obligations in place up to that date would normally be expected to be included in the price. However, changes to any existing schemes and obligations occurring after 2007 will not be included in the price before then. In light of this the uplift of £3/MWh appears reasonable with the exception of the cost of ROCs.

Suppliers have an obligation to purchase increasing amounts of ROC qualifying (renewables) generation or pay the ROC buy-out price. In 2005/6 the ROC obligation will be 5.5% of sales increasing to 10.4% by 2010/11. ROCs are traded separately from energy; hence the price of ROC obligations is not included in the energy purchase price. As the ROC obligation is dependent on sales (energy volume) the presence of losses will proportionately increase the ROC obligation and hence energy purchase costs to suppliers. Consequently, an uplift should be applied to take account of the ROC obligation. For 2004/5, the additional cost to suppliers of their ROC obligation[2] would be £1.73/MWh and in 2010/11 it would be £3.26/MWh.

This gives a total environmental cost of between £4.73/MWh and £6.26/MWh

Transmission costs

3.42

Though the use of peak demand capacity costs/prices is appropriate, it is unclear how Ofgem has derived the range of £1 to £4/MWh. If the range relates to different transmission costs for demand in different DNO areas then this should be reflected in different transmission cost components for different DNOs, i.e. DNO-specific incentive rates, rather than used as an upper and lower range for all DNOs. It would be helpful if Ofgem provided additional information on the derivation of the quoted range.

Distribution costs

3.43

As for transmission, though the use of peak demand capacity costs/prices is appropriate, it is unclear how Ofgem has derived the range of £10 to £21/MWh. If the range relates to different distribution costs for demand in different DNO areas then this should be reflected in different distribution cost components for different DNOs, i.e. DNO-specific incentive rates, rather than used as an upper and lower range for all DNOs. It would be helpful if Ofgem provided additional information on the derivation of the quoted range.

[2] Assuming cost to suppliers is at the buy-out price. The ROC buy-out price for 2004/5 is £31.39/MWh and is increased each year by inflation.

Overall incentive rate

3.44

With the exception of our comments in relation to distribution and transmission costs: -

- the cost of losses, hence losses incentive rate, should be higher;
- where there is some uncertainty or variability in cost the use of a mid-point value seems appropriate.

Targets for losses

3.45

Because of the annual variability in reported losses to date, using 10-year historical data to derive a target would appear reasonable. However, if there has been a reduction in reported losses over that period then it might be more appropriate to use a simple trend line using that 10-year data to derive a starting point for 2005/6. The data published by Ofgem in the various documents as part of the losses consultation indicates a downward trend in the level of losses for most DNOs.

Use of a ten year trend allows the variability of losses performance to be taken into account, yet it also allows for the separation of price control periods so that any "incremental change is valued at a consistent incentive rate to that which applied when the incremental change occurred"[3] in line with the perceived problem that Ofgem is addressing at the end of the next price control period. A simple funding mechanism in line with the existing control's incentive rate will need to be continued for incremental improvements occurring during this control.

If a 10–year average is used, as opposed to a trend, then most DNOs that have reduced their losses over the last 10 years will effectively receive windfalls at the start of the next control. In other words, as the proposed incentive rate is higher than the current one, even if DNOs do not show any improvement in losses performance at the start of the next price control, the DNO windfall will be the difference between the current incentive rate and the higher proposed rate for incremental performance improvements during the current control.

If Ofgem is to amend the scheme to lock in the incentive rate at the end of the next control in line with DNO concerns, it is only appropriate to have a symmetrical treatment at the start of the control in particular to avoid DNO windfalls.

<u>Other issues</u>

Capital expenditure eligibility test

We are concerned that there is not a tighter restriction on losses capital expenditure. It is our understanding that losses expenditure has not been included in the proposed capex allowances. Hence, in the main losses expenditure will be additional to the proposed capex. Whilst we recognise that capex is often multi purpose and that losses was not part of the recent customer willingness to pay survey, as the losses incentive rate valuation includes the environmental externality, the value arrived at can be seen as a reasonable proxy for customer willingness to pay. Consequently, the cost increase to customers of

[3] Electricity Distribution Price Control Review – Appendix – The losses incentive and quality of service – Paragraph 1.9 - Ofgem - June 2004

the incentive payment plus cost of losses capex should not be higher than the incentive valuation.

If this maximum is not enforced, then customer costs via DUOS charges will have increased faster than the energy purchase costs (plus value of environmental externality) avoided. Customers are unlikely to have been willing to pay more than this maximum. Moreover, a cost of losses reduction greater than this maximum would appear to fail the test of efficiency.

We would like consideration of this issue to be addressed as part of any final losses RIA.

Distributed generation protection

We are disappointed that DNOs are protected from the potential adverse effects of remote distributed generation yet DNOs will receive the entire proportion of any windfall benefit that might flow in the other direction from increased levels of non-remote distributed generation. It is inappropriate to proceed with this asymmetrical protection.

Metering

3.46

British Gas is a strong advocate of the development of metering competition and, having committed significant resources in moving the agenda forward, has been generally supportive of Ofgem's proposals to date. We believe that if Ofgem successfully creates a market that encourages new entrants, consumers will be the ultimate beneficiaries with higher service levels, innovative products and lower charges.

We welcome Ofgem's decision to introduce separate price controls for metering and distribution, since this will reduce the scope for DNOs to cross subsidise their potentially competitive metering businesses from their monopoly distribution businesses. We particularly welcome the publication of indicative numbers for meter asset provision (MAP) in Table 3.3 and meter operation (MOp) in Table 3.4 as this helps provide an insight into Ofgem's data collection exercise and the opportunity to sense check the allocation of costs and returns between metering and distribution activities.

However, our initial conclusions are that the numbers presented in this document fall well short of that required to ensure the development of an effective metering market. Our concerns relate to Ofgem's proposals for both MAP and MOp and are explained further below.

A key principle Ofgem must adhere to is that DNOs must not be allowed to increase charges in the metering price control without an equal and opposite adjustment being made to their distribution price control, since otherwise it would provide unjustified windfall returns to DNOs.

<u>MAP</u>

3.54

With regard to the Initial Proposals, we agree with the proposed introduction of a price cap for the provision of certain types of meters (outlined in Table 3.3) and a licence condition requiring the DNOs to use a non-discriminatory approach to calculate price capped and non price capped charges in relation to meters provided in accordance with standard licence conditions 36 – 36C.

We have previously supported the principle of valuing DNO meter assets on a depreciated replacement cost basis, since we believed that this was necessary to provide a level playing field for both new entrants and incumbents and remove any perverse incentive to replace meters prematurely. However, this support was on the basis that the cost of meters has been relatively stable and therefore assumed that the difference between depreciated replacement cost and depreciated historic cost would be marginal.

We also agreed that the difference between historic and replacement value should be recovered in network charges as, in total, this provides DNOs with the agreed remuneration on historical investments whilst protecting DNOs by limiting the exposure to the stranding of meter assets. We believed that this provision would be sufficient to provide the appropriate level of DNO protection.

Whilst we welcome the inclusion of Table 3.3 outlining the proposed price cap for the provision of domestic credit and prepayment meters, we are disappointed with the level of supporting details contained within the document. We believe that it would have been helpful to include additional details underlying the proposals, for example:

- the assumed depreciation periods for both the current and proposed charges;
- the cost elements that comprise the proposed charges;
- the total depreciated historic meter RAV;
- an assessment of the charges based on the total depreciated historic meter RAV using equivalent depreciation and other assumptions to the current proposals;
- an assessment of the charges assuming a new asset RAV (new entry costs); and
- average asset lives.

Without this information we cannot fully test where the problems lie or the extent to which the individual components contribute to the problem. This makes the consultation process less constructive than we would have liked especially given the limited time left before Ofgem concludes this review.

However, lack of detail aside, our understanding of Table 3.3 is as follows:

- Ofgem has derived the proposed range for the average charge for domestic credit and prepayment meters for each DNO using the depreciated replacement RAV, adding an element of opex and new capex allowance.
- The proposed range presented for each DNO reflects different assumptions on depreciation rates and opex with the higher figure representing the shortest assumed asset life and high opex allowance, the lower figure representing the longest assumed asset life and low opex allowance.
- The range between the DNOs (from 0.55 – 0.59 £/meter for SSE Southern to 0.96 – 1.49 £/meter for UU) is primarily a reflection of the depreciated replacement value of each DNO metering asset base i.e. the older the average life of the meter base the lower the charge. This will be dependent upon individual DNO replacement policies and cost allocation of metering activities between opex and capex. We also

assume that differing procurement practices will have an impact upon this range, i.e. prices paid for meters.

- These figures represent Ofgem's thoughts on charges for both existing and new meters.

British Gas has reviewed these figures with our commercial meter operators and has concluded that the proposed rates are significantly below those that are needed to encourage new entry to this market. We remind Ofgem of the gas experience where the metering price control was based on depreciated historic costs (and where the difference between historic and replacement is more pronounced in gas) and metering competition has become successfully established with Transco competing and winning contracts and without suffering from material stranding.

Meter provision in electricity distribution is a new market and therefore very fragile. We believe that only British Gas has so far entered into commercial contracts with commercial meter operators (MO). Currently there are only three commercial MOs whose business cases rely on being able to "sell" contracts for churn meters to other suppliers. If regulated prices for new meters are kept artificially low, it will incentivise suppliers to remove the commercial MO meter and replace it with a new DNO meter. This may not only give rise to a bad customer experience, but could also, ironically, create a stranded asset risk for the commercial MO.

Further, the proposed pricing structure is likely to dissuade other suppliers from using commercial MOs for their electricity meter work, effectively closing off 75% i.e. the non British Gas element of the electricity market. This is likely to make the market unattractive in the medium term and could cause the MOs to exit. Commercial MOs are likely to have built their business on a dual fuel operation; if electricity is unviable, the long-term viability of gas could also be at risk.

As we have not been privy to the procedure and assumptions that lie behind the source and derivation of these numbers, we are unable to do the detailed analysis required. However, below we explore possible reasons why the proposed ranges may not represent the charge level to create a sustainable competitive market.

1. Use of depreciated asset stock to set charges for new meters

We are concerned that the use of a partially depreciated (either on a historic or replacement cost basis) asset stock i.e. old meters, to set the competitive rate for new meters will result in insufficient allowed revenue to cover the costs of new meter providers.

To illustrate this concern we offer the following simplified example based on the following assumptions:

- the average life of a meter is 10 years
- DNOs operate an even installation and replacement policy
- no new build
- Straight-line depreciation.

In time the average age of the meter base will be 5 years i.e. 50% depreciated. Assuming a replacement cost of a credit meter remains at £10, the average depreciated replacement value of a credit meter will be £5 i.e. half that of the value a new entrant will face assuming a similar depreciation period and profile. If charges are set on returns based on depreciated assets, it is clear that, all things being equal, a new entrant will not be able to compete.

We appreciate that in the long run a new entrant's average asset life will tend towards that of the existing DNOs but that assumes that a new entrant is prepared to accept losses in the short run. We doubt this will be the case.

2. Inappropriate allocation of meter RAV between depreciated historic value and depreciated replacement value

As no indication of the depreciated historic meter RAV has been provided, we are unable to determine whether the allocation between historic and replacement value appears reasonable. We are concerned however that the incentive will be for DNOs to allocate meter value to the distribution price control i.e. over-estimate the historic value and underestimate the replacement value. Allocating value to the distribution price control will inappropriately protect meter investments from competition and hence possible stranding and reduce the competitive opportunities in metering activities.

3. Not all the costs of metering have been included

As with the previous point, we are concerned that when allocating costs (including opex and overheads) the incentive will be to allocate these costs to the distribution price control. Again, the lack of supporting details means we are unable to comment on how material this may be.

MAP Conclusions

In Ofgem's principles for the design of the metering price control, the key assumption is that price controls based on depreciated replacement costs would produce charges sufficient to encourage new entrants. However, this does not appear to be borne out in the figures contained within the Initial Proposals.

Based on a review of the reduction in charge from current to proposed, it is our understanding that DNOs appear to have a significant amount of unwarranted protection. We estimate this to be in the region of 50% of depreciated historic RAV.

We accept that Ofgem's range may well reflect the long term average of meter costs (assuming no inappropriate cost allocation), but this will not be sufficient to encourage new entrants who will be faced with losses in the short run until their average meter asset lives are in line with those of the DNOs.

Given the lack of supporting detail in the Initial Proposals, it is difficult to establish where the problem actually lies but it may be due to one or more of the reasons outlined above.

Potential solutions to this may be to set charges at the lower of either the un-depreciated replacement basis (equivalent to new entry costs) with any remaining value recovered though the distribution price control or at historic depreciated cost with no residual in distribution price controls. If, however, new entry cost levels cannot be reached through this approach i.e. the latter option, then two price controls may be necessary; one for existing meters based on depreciated replacement costs and one for new meters based on new entry costs. This approach helps to create a level playing field for the new commercial meter MOs to compete with the established DNOs, allowing both to operate on the same basis. This is more aligned to gas, where Transco have offered a lower price for the installed stock (in return for a commitment to a long term contract) and a higher price for "new and replacement meters" installed after 1.1.2004.

A solution that would not be acceptable would be to simply increase the allowed charge by increasing the rate of depreciation. This may provide a temporary fix but would exacerbate the problem in the medium term.

As stated earlier a key principle Ofgem must adhere to for any changes is that DNOs must not be allowed to increase charges in the metering price control without an equal and opposite adjustment being made to their distribution price control. This would provide unjustified windfall returns to DNOs.

We also note that these solutions do not offer any additional headroom to encourage new entrants and we suggest Ofgem needs to consider the level and duration of headroom needed as was the case for the last set of electricity supply price controls.

MOp

3.61

We understand that Ofgem's proposals for meter operation are less developed than those for meter provision and that the details provided in Table 3.4 only provide an outline of the DNOs' meter numbers and total opex. We understand that Ofgem intends to review and challenge these figures further to identify what services are included e.g. installation costs, overhead allocations and margins. We welcome this challenge.

We are, however, concerned by Ofgem's apparent proposal to work with the DNOs to finalise these numbers before issuing final proposals. We suggest that this is bypassing the consultation process and urge Ofgem to allow suppliers and other interested parties the opportunity to comment on these proposals before they are issued as final.

Once again we must stress that a key principle Ofgem must adhere to for any changes is that DNOs must not be allowed to increase charges in the metering price control without an equal and opposite adjustment being made to their distribution price control. This would otherwise provide unjustified windfall returns to DNOs.

4. Quality of service and other outputs

Revenue exposure to quality of service incentives

4.8

We welcome the customer support for strengthening of incentives. The proposed revenue exposure levels appear reasonable, in particular the increased incentives on the Interruption Incentive Scheme and storm compensation arrangements.

Standards of performance

Severe weather standard

4.16

We welcome the intention to simplify the arrangements for normal and severe weather by including them both under a single scheme of a licence condition rather than the somewhat customer-confusing existing arrangements of a mixture of Guaranteed Standards (GSs) and licence condition. However, one of the advantages of the existing GS approach is the relatively high profile of the standard and the need for suppliers to make customers aware of the standard. It would be a pity if this advantage was lost as it might further reduce the likelihood of affected customers receiving appropriate compensation.

Semi-automatic payments

4.18

We welcome Ofgem's confirmation of the intention to ensure that the existing perverse incentive on DNOs is reduced by ensuring that DNO revenue is reduced irrespective of whether or not an eligible customer applies and receives compensation. This important change should also strengthen DNO incentives to appropriate levels.

Compensation for HV connected business customers

4.21

Even though business customers do not regard small increases in compensation as adequate, increasing compensation levels would better align DNO incentives with the actual harm caused by their failure, leading to DNO performance to better reflect efficient levels. Ofgem should reconsider the intention to maintain the existing arrangements.

Interruption incentive scheme

Form of the incentive scheme including the weighting of planned interruptions

4.32

We welcome Ofgem's confirmation of a symmetrical incentive scheme

4.33

Whilst we support the increase in CI and CML incentives/exposure, ideally we would have liked the scheme to be extended to include the volume of energy unsupplied, whilst maintaining total DNO exposure because of the overlap in the three measures. This change would have better aligned DNO incentives with regards to the real costs of their failure particularly with respects to larger customers. However, we understand that this information is not yet available. Perhaps this information could be prospectively collected under the RIGs and DNO performance incentivised under the proposed "discretionary award".

4.34

We welcome the customer support for differential incentives on planned and unplanned interruptions.

Setting targets - number of interruptions

4.35/4.37/4.38

It is not possible to adequately comment on the appropriateness of the proposed benchmarks as Ofgem has not published enough information on the disaggregated performance that makes up the benchmarks. Additionally, from table 4.2 it appears that the benchmark may be based on performance assessed over the 2001/02 to 2003/4 periods, whilst paragraph 4.35 notes that the benchmarks are based on 2002/3 and 2003/4 performance. We would welcome the publication of additional information underlying the proposals and clarification of the period over which company performance has been assessed.

Whatever the period of assessment, an average performance over a number of years has been used. It would have been better to use trend performance over the same number of years. This approach would take account of year on year volatility, whilst also taking greater account of the average year on year improvement in company performance that is best illustrated by table 4.2 - DNO "Average" performance. This would result in the benchmarks being lower (more challenging) for most companies and would better reflect current and likely future performance.

0.5% per annum improvement in the benchmark appears unchallenging in light of the significant improvements in overall performance seen recently. How does this compare with actual levels of improvements?

4.39

It is curious that a company that is performing short of a benchmark, i.e. its performance is not at an efficient level, is being paid in full to improve its performance through increased capital allowances. Surely, if frontier performers are being rewarded for their performance[4] by being allowed to earn above average rewards, inefficient companies should be penalized by earning below average returns either by reducing their overall revenues by 1% per annum or by funding only a proportion of the capital expenditure required to improve that performance.

Setting targets - duration of interruptions

4.40/4.41

As for number of interruptions, it is not possible to adequately comment on the appropriateness of the proposed benchmark as Ofgem has not published enough information on DNO performance. As before, it would have been better to use trend rather than average performance.

[4] Ofgem proposes to reward WPD South West and WPD South Wales an additional reward of 1% per annum.

4.42

See comments at paragraph 4.43 below.

Summary of targets and associated cost allowances

4.43

We are unsure how Ofgem decided whether or not a company's capex allowance should be increased to allow it to meet its required target level. For example, did Ofgem cap the company £/CI and £/CML capex allowance plus the cost allowance for operational improvements at the values determined by the information received about customers' willingness to pay or alternative international assessments? We would welcome further clarification from Ofgem about the cost effectiveness of the proposed quality cost increases.

Rewarding current best practice

4.45

Whilst generally being in favour of rewarding best practice we do not support the current proposals as frontier performers are being rewarded with increased rates of return while poorly performing companies are not being penalized. We do not support this asymmetrical treatment.

Setting incentive rates

4.48

It might have been better to combine the bottom-up and top-down approaches to arrive at the DNO incentive rates.

4.50

We would only support the use of wider performance bands or dead-bands for companies with high levels of volatility if the benchmarks were based on the trend rate of performance, rather than the average over a number of years, in line with our earlier comments. In particular, as most companies have shown an overall level of improvement despite the volatility, the trend would better reflect both current and potential for future performance.

Audits and adjusting data for inaccuracy

4.53

We support the tightening of the overall accuracy requirements from 95% to 97% but would welcome further Ofgem clarification about how the individual components of that overall level will be affected.

Frontier performance for this price control period

4.54/4.55

As per our earlier comments on setting company benchmarks, as most companies have shown year on year improvements it would be better to use trend performance rather than the average. Use of a trend would take account of year on year volatility whilst placing a greater emphasis on the overall direction that performance is moving in. For those companies that have shown most improvement, this test would show better performance relative to the benchmark.

Storm arrangements

4.60

We welcome the intention to increase the DNO exposure, remove the cost-pass through arrangements, increase the lower gate from 7 to 8 times daily fault levels and the upper gate from 25% to 50% of affected customers. When the interim arrangements were introduced we were concerned that they may not have adequately incentivised DNOs and consequently may not have been in the interests of customers. These changes if implemented are likely to address our main concerns.

4.62

In light of the significant increases in capex expenditure (as capex is often multi-purpose, a significant increase in capex is likely to lead to additional improvements in other areas including quality of supply) and the proposed revised storm arrangements with enhanced DNO incentives, it appears both unnecessary and premature to provide additional DNO capex allowances to improve network resilience at DPCR4.

If necessary this issue could be reconsidered at the following price control review.

Incentives for the speed and quality of telephone response

4.68

We support the intention to remove the relative scheme whilst maintaining relatively strong incentives to prevent performance deteriorating and providing some limited incentive to improve performance.

4.69

Broadening the scheme to include customers' satisfaction with the speed of telephone response is a pragmatic solution to the inability to adequately benchmark company performance in this area. We also support the intention to include customers who received an automated message, from 2007, subject to the reasonable costs of implementation.

4.70

In light of the importance of DNO communications during an exceptional event, we welcome the intention to extend incentives in this area from 2007.

Undergrounding in Areas of Outstanding Natural Beauty

4.75

In light of other proposals to improve DNO performance in areas with an environmental impact i.e. Distributed Generation and Losses, and since DNO investment is increasing significantly during the next price control, we support Ofgem's intention not to allow additional costs in this area.

Environmental Reporting

4.78

We support reporting via the RIGs.

Discretionary award

4.84

As noted earlier in this response (at paragraphs 3.1 and 4.33), perhaps DNO performance in respect of producing estimates of the theft element of losses and energy unsupplied respectively could also be incentivised as part of this award.

6. Cost Assessment

Conclusions on alternative regressions

6.51

Ofgem is proposing to use the higher of three alternative regressions and the base regression. As Ofgem notes that it has less confidence in the alternatives, Ofgem's proposals are likely to be overly generous to DNOs. Ofgem should set costs on the basis of the base regressions. As a second best option Ofgem could use the higher of the average of the alternative regressions and the base regression.

6.56

We fully support the Ofgem intention and rationale not to provide a glide path or partial catch-up for companies not achieving upper quartile costs. The greater confidence in the base regressions and the use of upper quartile rather than frontier costs make both of these mechanisms unnecessary this time round.

Total opex allowance

6.57

The price control should be set on the basis of reasonably forecast future efficient costs. That is, the extent to which DNOs can be reasonably expected to improve their efficiency faster than the rest of the economy should be reflected in changes to the opex frontier, the real X. If DNOs perform to those forecasts then they will earn average rates of return commensurate with their WACC. If DNOs out-perform those forecast efficient costs then they can retain the relevant out performance incentives and earn rates of return greater than WACC. DNOs should not be gifted rates of return higher than WACC just because they can be expected to improve their efficiency faster than the rest of the economy.

The detail of CEPA's DNO efficiency report for Ofgem would support historical and potentially ongoing efficiency improvements for opex in the range 3.7 to 7.7%, after taking account of efficiency improvements in the rest of the economy. We do not believe that CEPA's conclusions for much lower levels of X for opex are supported by their own results. Even if Ofgem were to take a conservative view of the historical data to project future efficiencies, the detail of CEPA's report would imply that X for opex should be set no lower than 4% per annum, consequently we do not support the use of a real X=2, i.e. ongoing cost reductions of only 2% per annum.

Historical capex and RAV roll forward

6.67

In line with our previous comments we look forward to a robust review of DNOs' asset disposals, in particular those that have been transferred into related companies, or as part of the Utilities Act Transfer Scheme 'left behind' in other related companies.

Review of future capex

6.71

Though the LRE and NLRE models may have been shared with DNOs, very little information is presented in the Ofgem report about how capex allowances are set. In particular, what if any assumptions were included in those models about year on year efficiency improvements? We would urge publication of a much greater level of detail, especially the key assumptions underlying the models including how unit costs have changed since DPC3. There has been a significant increase in capex expenditure for DPCR4; this significant area of expenditure requires a greater degree of transparency. This should aid scrutiny of the proposals by non-DNOs.

7. Financial Issues

The cost of capital

7.1

We understand that for the Initial Proposals, Ofgem's modeling assumptions have been based on a 6.6% pre-tax cost of capital, this being the mid point of the proposed range of 6% to 7.2%.

Whilst we acknowledge that no firm decision has been made on the appropriate cost of capital, we reiterate our view 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. Accordingly, our overall position on the cost of capital remains that, whilst there is also little evidence to point to a lower cost of capital than assumed at the last review, there is little evidence to support a significantly higher cost of capital. In particular we consider that there is little to support the upper limit of 7.2% pre-tax cost of capital.

We understand that in Ofwat's Draft Determinations, it has proposed a 5.1% post-tax (or 7.3% pre-tax) cost of capital that represents an increase on the allowed cost of capital, under the present price control, of 0.35%. However, we understand that this increase is driven primarily by the requirement for companies to undertake large capital programmes that will result in persistent negative cash flow. This can lead to deterioration in credit quality that could restrict companies' access to capital markets or significantly increase their cost of finance. Consequently, Ofwat's draft price limits include around 0.5% for 2007/08 rising to 1% by 2009/10 to maintain finaceablity.

It is also our understanding that such constraints do not present themselves in the DPCR4 with Ofgem's financial modeling showing strong financial ratios to the point where, for some DNOs, it would be possible to reduce prices. We agree with Ofgem that if only a small number of companies are affected by cash flow problems, and there is not a general financial constraint across the sector, it is reasonable to assume that, rather than allow credit quality to deteriorate, shareholders would provide additional equity to fund increased capex provided they have reasonable prospects of receiving appropriate returns on their investments.

In conclusion, whilst we accept that there is an upward risk associated with the increased size of the capital programme that will impact on the asset β, we also note that there is a downward pressure resulting from the increase in gearing. We support the use of the mid point of range (6% to 7.2%) i.e. 6.6% pre-tax cost of capital, an increase of 0.1% from current WACC but no higher.

Pensions

7.18

We support Ofgem's proposals to make no adjustment for Early Retirement Deficiency Costs (ERDC), as we consider it is reasonable to expect companies to absorb any increase, or retain any benefit of any decrease, in the cost of providing enhanced pension benefits granted under severance arrangements that have not been fully matched by increased contributions.

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

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

With regard to the first bullet point we are concerned that Ofgem does not appear, from Table A1: Detailed Normalisation Adjustments, to have included pension costs in its top down efficiency modelling. Clarification as to why these costs have been removed from the benchmarking exercise would be appreciated. As a lesser alternative, we believe that DNO pensions costs should be benchmarked separately. However, as with pensions being benchmarked as general opex, there is no evidence that this approach has been taken.

Tahir Majid & Roddy Monroe/Regulatory Affairs/British Gas/ 09.08.2004