Cemil Altin
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BY E-MAIL

9th August 2004

Dear Cemil,

Electricity Distribution Price Control Review

Attached is energywatch's response to the initial proposals document issued by Ofgem.

The response is in two parts, an executive summary of the key points in the response, followed by specific comments on the questions raised and proposals set out in the document.

If you have any questions or comments, please do not hesitate to get in contact with me.

Yours sincerely

Lesley Davies
Director of Policy
energywatch

Electricity Distribution Price Control Review

energywatch's response to Ofgem's Initial Proposals

August 2004

Summary

energywatch welcomes the general direction of the initial proposals and welcomes Ofgem's acknowledgment of many of the points we have previously made. Even so, we believe that the proposals package can be improved further to protect the interests of consumers more effectively. In particular, we are concerned that the proposals for meter asset price caps are a retrograde step that fails to protect vulnerable consumers and we offer an alternative approach.

Our key points are as follows:

The meter asset price cap

1. Vulnerable consumers using prepayment meters should be receiving the same degree of protection as other consumers. The initial proposals for the meter asset cap discriminate against them by expecting average charges to increase, while the standard credit meter cap will decrease.
2. Ideally, the Scottish companies' policy of offering prepayment and standard credit meters at the same price will be introduced for all DNOs, but as a minimum, the meter asset price cap should be set so that total savings are evenly applied across both prepayment and standard credit meters.

The form, structure and scope of the price control

3. The use of RPI as the reference index should be kept under review and should take account of the index which is most applicable for consumers and their ability to pay.
4. Revenue protection services should not be excluded services and should be a part of DUoS charges, rather than a transactional charge.
5. We strongly support the proposal to equalise incentives for all categories of efficiency savings and question whether it is appropriate to permit differential incentives at all.
6. We concur with the proposals to not introduce a formalised mechanism for dealing with uncertainty. We do not favour the use of re-openers, as these weaken the incentives on DNOs to manage the pressures on their businesses and leave consumers to pick up the bill.
7. Consumers should only be asked to pay more when sustained improvements in performance are achieved. The current losses proposals do not pass this test and the proposal should revert to adjusting the target level of losses as originally proposed.
8. The proposed timetable for changing the metering related standard licence conditions is too ambitious. The removal of these conditions must be subject to an assessment of the state of competition at that time. 2007 is the earliest that such an assessment should be undertaken.

Quality of service and other outputs

9. We welcome the increased exposure of DNO revenues to quality of service performance and the stronger incentives for improvements in quality of

supply, provision of information and restoration of supplies following severe weather events.

10. Adjusting allowed revenue for any non-payment of compensation under the standards, while better than no action, is a weak alternative, as those consumers affected by an outage will still not receive the compensation they are due and a price control adjustment will be smeared across all consumers.
11. Increases in business compensation payments should be funded by shareholders, rather than consumers, as these payments are born out of the failure of the company to deliver the agreed level of service.
12. Targets for the interruptions incentive scheme should be based on the performance of each DNO, not an average across all companies, and should require absolute improvements.
13. Giving poorer performing companies additional allowances under the interruptions incentive scheme creates an inappropriate incentive. If the allowances are retained, we would expect them to be subject to more detailed scrutiny so that it is clear that they are spent on projects to improve interruptions performance.
14. We welcome the developments to the storm compensation arrangements. Although we do not favour the use of re-openers, the high impact, low probability nature of severe weather events means that this is one area where a re-opener may be a more appropriate solution than providing a set allowance for each year.

Distributed generation

15. We agree that the number of applications for Registered Power Zones should be limited to two per licensee per year. Ofgem's assessment process will need to demonstrate how they have protected the standard of service given to consumers and to identify that a DNO will have to face genuine additional risks from employing the scheme.

Cost assessment and financial issues

16. We would urge Ofgem to build quality of service indicators into the regression model at the earliest opportunity.
17. We support the use of upper quartile performance as the benchmark and agree it is inappropriate to smooth the path of cost reductions.
18. We welcome the effort to give greater incentives to companies that produce accurate forecasts through a sliding scale mechanism. However, we do not agree that companies need to be given two additional incentives in the form of additional revenue and a capex allowance that is above PB Power's assessment of justified capex.
19. Ofgem needs to develop a strategy for removing the depreciation adjustment, which results in consumers paying for assets more rapidly than their assumed asset life and higher charges.
20. If a DNO does have ratios below the test levels, any adjustment should come from shareholders.
21. An X factor of 1 should be the minimum that is used and that 1.5% could be justified.

energywatch's response to Ofgem's Initial Proposals document

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1. <u>Introduction</u>

Consumers want electricity distribution network operators (DNOs) to be virtually invisible, so that they provide a reliable, high quality service at a reasonable cost. The price control is a key tool both for influencing the quality of service that DNOs provide and for restraining their spending plans.

energywatch notes that many of the points we have previously raised have been taken on board by Ofgem in forming the initial proposals. However, while we welcome the general approach, the package of proposals, and particularly the metering price control proposals, needs to be improved to better reflect the interests of consumers.

The remaining sections provide our comments on the package of measures in the initial proposals document and its appendices. Section 2 sets out our serious concerns about the proposals for the meter asset price cap. Section 3 covers issues about the general form of the price control and section 4 deals with the approach to quality of service and other outputs. Section 5 draws together our comments on the more detailed cost modelling and financial issues discussed in the document.

2. The impact of the meter asset provision proposals on vulnerable consumers

Vulnerable consumers will be protected less
We are very concerned that the approach proposed for setting the meter asset price caps will adversely affect vulnerable consumers who use prepayment meters. Consumers using prepayment meters are overwhelmingly those in more vulnerable groups. While prepayment meters account for 16% of electricity consumers, they are used by 51% of single parent families, 37% of households with an income of less than £4,500 and 38% of households on benefits.

Since privatisation, companies have used prepayment meters as an alternative to disconnection. In 2003, 154,000 were installed for this purpose. The decision to install a prepayment meter is rarely the consumer's choice, so these consumers should be receiving the same standard of protection as consumers using standard credit meters. However, the proposals anticipate that domestic credit meter charges will decrease on average by 38-49%, yet that prepayment meter charges should increase on average by 10-41%

We are particularly concerned about the proposals for SP Distribution and SSE Hydro, who use prepayment meters more frequently than average, where charges for prepayment meters in these areas could potentially triple. This approach would unwind a policy of charging all domestic consumers the same for providing a meter. The Scottish companies were praised when they introduced this policy and these proposals are a retrograde step.

Company goodwill cannot be relied on
We agree with Ofgem that the functionality of many prepayment meters currently in use results in a lower quality service to prepayment consumers. However, these proposals will mean that prepayment meter consumers, as well as receiving a lower quality service, will incur on average higher charges. Without further action, we cannot share Ofgem's sanguine view that DNOs might not price up to the price controlled level or that innovation may mean that overall supplier charges to PPM consumers could be reduced over time. Past experience has shown that companies will price up to the maximum permitted under price controls, while the premium paid by prepayment customers has fallen by less than 1% since 1995.

Accounting treatment concerns
It is claimed that the proposals for the prepayment meter cap are more closely related to the actual cost of provision than current charges. Yet, for the equivalent domestic credit price cap, a significant element of the costs has been moved from the metering control into the distribution price control. In addition, allocating meter operating expenditure on a weighted average value basis places an undue proportion of these costs on prepayment consumers as a result of the shorter asset lives of prepayment meters. We suggest that a per meter basis is a more equitable apportionment of this element of the costs, as this does not apportion costs on the basis of accounting practices. Ofgem are proposing that non-discrimination provisions should be introduced between price capped and non-price capped charges, which we support, however Ofgem's own actions do not appear to satisfy this principle. In effect, Ofgem's proposals in this area say that prepayment meter consumers are second class.

A preferable approach

We suggest that Ofgem should revisit this area entirely. The approach to metering is inconsistent with the rest of the price control proposals, which establish an overall price change for all consumers in an authorised area, and so fails to protect more vulnerable consumers. Our preferred outcome is that all DNOs adopt the existing policy of the Scottish companies and equate the prices for both types of meter, but as a minimum, we would expect Ofgem to:

- ensure, and state that, the same cost attribution policies are applied to standard credit and prepayment meters;
- look at the total savings available from providing standard credit and prepayment meters and set the price caps so that both types of meter received the same percentage reduction; and
- consult on whether further regulation is needed to so that the same meter asset prices are offered for standard credit and prepayment meters.

We believe this provides a much more equitable outcome than the current proposals. DNOs may argue that, under this approach, changes in meter type usage could expose them to unrecoverable changes in costs. However, this will also provide DNOs with an incentive to manage their meter population so that more efficient types of meter are used. We repeat our preference that the Scottish companies' approach is applied across all DNOs, but as an interim measure urge Ofgem to adopt this approach.

3. The form, structure and scope of revised price controls

The form, scope and incentive framework
We repeat our support for including EHV consumers within the scope of the price control. We agree that there should be no volume driver associated with EHV revenue, as to do otherwise would allow a DNO to recover these costs more than once.

We note the reasons given for using RPI as the price index for the next price control period. The choice of price index should be reconsidered as part of each review and should also take account of the index which is most applicable for consumers and their ability to pay. This will be particularly pertinent for vulnerable consumers who may be on low incomes or benefits linked to an index other than RPI.

Revenue protection services
We do not support the development of revenue protection services as excluded services. Responsibility for the detection and prevention of theft lies with suppliers and it should be up to suppliers to decide how best to discharge those responsibilities. Where DNOs choose to provide these services, they should do so only in the capacity of a supplier's agent so that there is a clear and unambiguous line of accountability. The current transactional basis creates a clear disincentive on suppliers to share suspicions of illegal abstraction as they then become responsible for all associated investigation costs. Charging suppliers through DUoS charges on a pro rata basis would encourage suppliers to make full use of a service for which they have already paid.

Equalising incentives
We agree with Ofgem that it is inappropriate that DNOs benefit from reclassifying costs and strongly support the proposal to equalise the incentives for all categories of efficiency savings for the next price control period.

We question whether it is appropriate to permit differential incentives at all. Consumers pay an all-in price to cover both capital and operating expenditure and are interested in improvements in the total productivity of a DNO. More robust reporting arrangements may help us understand how improvements can be achieved in particular areas, but we also need a more holistic understanding of how the parts fit together. Returning to differential incentives will be a retrograde step as it will increase the emphasis on improvements to parts of the system, rather than the system as a whole.

Dealing with uncertainty
We concur with the proposals to not introduce a formalised mechanism for dealing with uncertainty. An intrinsic feature of the price control process is that it has to deal in forecasts and estimates for an uncertain future. If DNOs wished to pursue such an approach, consumers would also seek greater certainty about DNOs' future actions.

We do not favour the use of re-openers, as these weaken the incentives on DNOs to manage the pressures on their businesses and leave consumers to pick up the bill. If legitimate additional costs are expected, but cannot be forecast adequately during the price control process, specific arrangements should be put in place to protect consumers. Changes to the Electricity Supply Quality and Continuity Regulations 2002 and line clearance work may warrant such an approach, although we are not convinced that these are legitimate grounds for re-openers, as without further justification they do not appear to be of significantly greater uncertainty than other elements of DNOs' activities such as the details of capital programmes.

Further, we do not believe that the introduction of the Traffic Management Act warrants a re-opener. The Act should be in force before the final proposals document is published, the possible costs associated with introducing the Act will have been the subject of a regulatory impact assessment, while the likely exposure to those costs will depend on the DNOs' work schedules, which will have been an input to the operating expenditure forecasts for the price control. We believe, therefore, that sufficient information should be available to specify fixed allowances without the need for a re-opener.

The losses regime

We support the principle of the arrangements proposed, but are concerned that consumers will be paying more without seeing a sustained improvement in performance. For example, using the figures in Table 1 of the Appendix, a DNO's adjusted incentive payment would be +24 over ten years, yet the cumulative recorded losses for the period would be -1; i.e. losses would be greater than the allowed losses. This does not operate in consumers' interests.

The objective for the losses regime should be a sustained reduction in losses. As modelled, the current proposals do not meet this test, so the mechanism should revert to adjusting the target level of losses as originally proposed.

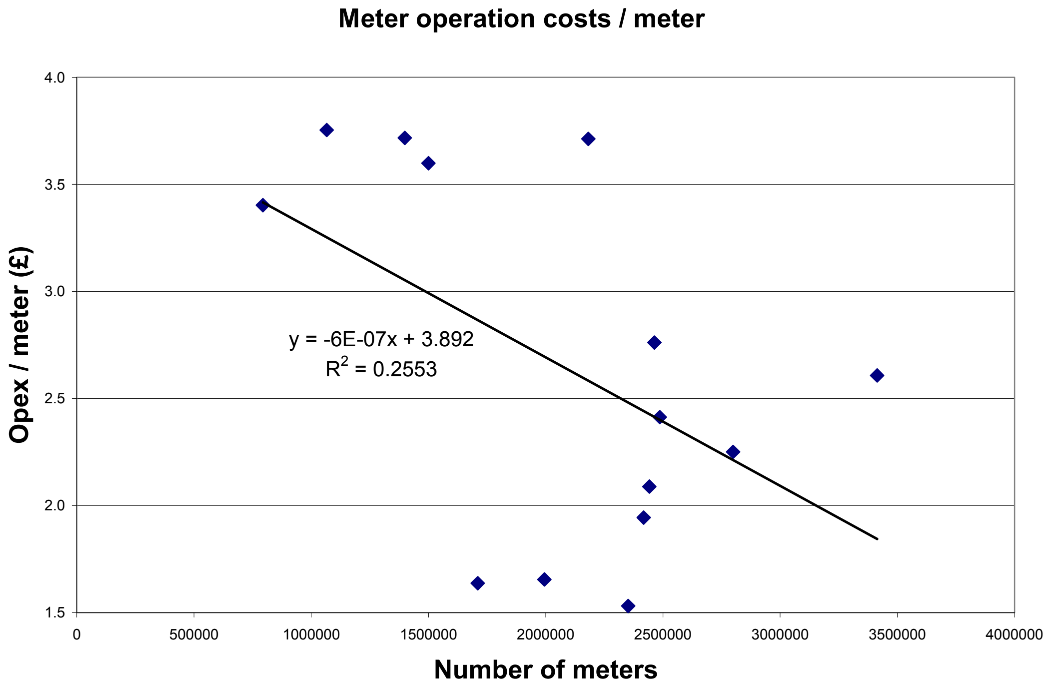
In addition, the even-handed structure of the proposed incentive rate would result in DNOs being paid twice for assets that help reduce losses, once through the normal action of the price control and a second time through the losses incentive. We suggest that the incentive is asymmetric, so that excess losses are penalised at the proposed rate of £48/MWh, while improvements receive £32/MWh; i.e. the proposed rate less the distribution cost element. Costs incurred in making the savings would be recovered through the normal action of the price control.

Other metering issues

We believe Ofgem is being too ambitious in its proposals for the changes to the standard licence conditions. Metering is an essential service for suppliers and consumers and the regulation of metering needs to facilitate effective competition in supply. To stipulate at this time the removal of these conditions from 1 April 2007 requires an unjustifiable assumption that competition will be effective at that time. Competition in the domestic supply sector has been more vigorous than that which is expected for metering, yet price controls remained in place until four years after market opening. The removal of these conditions must be subject to an assessment of the state of competition at that time and we consider that 2007 is the earliest that such an assessment should be undertaken.

We also repeat our comment that defining basic services as those available to meet licence obligations as at 1 April 2003 is insufficient. This obligation needs to be forward-looking, particularly to the introduction of small scale distributed generation in LV-connected premises. We would urge Ofgem to extend the scope of this definition to include the services and assets required for such projects, so that current and future consumers who are interested in such developments have at least one provider of the essential metering services.

As the graph below illustrates, the meter operation costs presented in table 3.4 vary widely and the trend line suggests that there is only a limited association between consumer numbers and costs or that the costs are not fully comparable. Further information is required before we can support these indicative figures.



4. <u>Quality of service and other outputs</u>

Revenue exposure to quality of service incentives
We welcome the increased exposure of DNO revenues to quality of service performance and the stronger incentives for improvements in quality of supply, provision of information and restoration of supplies following severe weather events

The standards of performance
We support the strengthening of the standards so that DNOs should pay out automatically, where possible, and the proposal that DNOs should be able to make payments directly to consumers.

However, the proposal to adjust allowed revenue for any non-payment of compensation under the standards, while better than no action, is a weak alternative, as those consumers affected by an outage will still not receive the compensation they are due and a price control adjustment will be smeared across all consumers, not just those affected by an outage. In addition, when faced with an administrative exercise to send payments to consumers or generating an accounting estimate of how much would have been sent out to consumers, the lower administrative effort required for the latter will incentivise companies to rely on the price control adjustment. Ofgem should be requiring the companies to introduce automatic payments so that consumers receive the compensation they are due. As a minimum, if companies fail to make automatic payments, the price control adjustment should also deduct an estimate of the administration costs saved.

We are disappointed that Ofgem have not seen fit to unwind the existing inequity between business and domestic consumers, so that compensation to business consumers accounts for a much lower proportion the distribution charges paid. A typical business consumer uses more units and pays more for the service they receive, yet the compensation arrangements do not recognise this. Increases in business payments should be funded by shareholders, rather than consumers, as these payments are born out of the failure of the company to deliver the agreed level of service. Willingness to pay is irrelevant when considering how much compensation should be paid for a failure to deliver.

The interruptions incentive scheme
We support the changes to the scheme that introduce symmetric annual rewards and penalties and a greater emphasis on the duration of interruptions. The 0.5% per annum improvement in the benchmarks for the number of customers interrupted sounds plausible, however, without any corroborating evidence about how this figure was derived, we cannot give this out full support.

We are concerned, however, that the targets being proposed for 2010 are more relaxed than those set for the current IIP. As with losses, this is an area where consumers should receive sustained improvements in performance. Targets should be based on the performance of each DNO, not an average across all companies, and should require absolute improvements. Even if a DNO's performance is better than average, consumers will be dissatisfied if performance deteriorates. Consumers cannot switch networks to secure better performance, so the targets need to give DNOs the incentive to continuously improve.

Providing additional allowances to enable weaker performers to improve also appears to set an inappropriate incentive – get paid for performing worse. We are also concerned that establishing these additional allowances will incentivise DNOs to think of quality of supply issues separately from the general development of the network. We therefore do not support the additional allowances proposed. If the allowances are retained, we would expect them to be subject to more detailed scrutiny so that it is clear that they are spent on projects to improve interruptions performance.

We are also unclear why the performances of WPD South Wales and WPD South West warrant the receipt of additional allowances over and above the benefits they are receiving under the current IIP and those they will receive if they continue this performance under the new scheme. If this is because the limits to schemes constrain the likely benefit they might receive, we would rather see a greater proportion of revenue exposed under the incentive scheme, which would also give all companies a greater incentive to seek better performance.

We agree that each DNO's data should be adjusted to take into account any inaccuracy identified by the audits of interruptions data and support tightening the accuracy requirements to 97% over the next price control period.

The revised storm compensation arrangements
We welcome in principle the refinements to the gates proposed for the next price control period and welcome the removal of the pass-through element of the arrangements. We do not support, however, the annual cost allowance for exceptional events and particularly Ofgem's willingness for this allowance to use to buy insurance cover, rather than improve the performance of a network. As with the proposed interruptions allowances, if the DNOs are to have such allowances, they should be subject to more detailed scrutiny and should be closely linked to dealing with severe weather events. Although we do not favour the use of re-openers, the high impact, low probability nature of severe weather events means that this is one area where a re-opener may be a more appropriate solution than providing a set allowance for each year.

We note the range of values for the fault thresholds and would welcome Ofgem's assessment of whether any of the networks are more susceptible to HV faults than others, or whether these differences can be accounted for by the different sizes of the networks. Our concern is that consumers in some areas may have to fall back on the lower standards of the storm arrangements when consumers in other areas which are less susceptible would be able to employ the usual guaranteed standard for supply restoration.

Changes to telephony incentives
We welcome the enhancements proposed in this area.

5. <u>Other issues</u>

Distributed generation incentives

We support the inclusion of microgeneration within the scope of the distributed generation incentive and the additional threshold for high-cost projects.

We support the framework laid out for the Innovation Funding Initiative mechanism and particularly welcome the positive link that will need to be shown in advance between the costs and benefits of these projects and the publication of the project justifications. An important part of the review in 2007 will be to hold a post-event audit to see how accurate the justifications will have been in practice

The proposed changes to the Registered Power Zones (RPZ) incentive
We welcome Ofgem's emphasis on the potential impacts that any RPZ proposal could have on consumers, particularly where a DNO is seeking a relaxation from the normal statutory standards. We expect Ofgem to demonstrate how it has protected the standards of service given to consumers.

We note the proposal to increase the incentive rate to apply for RPZ schemes and would stress the importance of Ofgem's assessment process identifying that there are genuine additional risks that a DNO will have to face from employing the scheme. Again, the review in 2007 should consider how significant the risks have been for any projects that are in operation.

We agree that many issues to do with RPZ projects will only come to light when the first registrations and proposals are received. Given the learning curve that all parties will have to face, we agree that the number of applications for registration should be limited to two per licensee per year.

Cost assessment and financial issues

The approach to assessing operating costs
We note that Ofgem have employed a similar approach to the base regression analysis to previous reviews. It is disappointing that Ofgem have not taken the opportunity to embed quality of service performance more fully into the price control by including customer interruptions and customer minutes lost information into the construction of the composite scale variable. This would appear to provide a more rigorous means of ensuring that low cost does not mean low quality than the assessment described and we would urge Ofgem to take this forward at the earliest opportunity.

We support the use of the upper quartile as a benchmark. To use the average as the DNOs were suggesting would not introduce any efficiency gains into the benchmark, but would merely pass money from one company to another.

We support Ofgem's view that it is not appropriate to use catch-up percentages or a glidepath to smooth the cost reductions required by the price controls. Consumers expect a high quality, economical service and to give poorer performers additional revenues undermines the incentives to improve.

The assessment of capital expenditure and the proposed sliding scale mechanism

Consumers want the price control to incentivise genuine improvements in performance, rather than informational game playing. The sliding scale approach is an interesting development and we welcome the effort to give greater incentives to companies that produce accurate forecasts.

However, we do not agree that companies need to be given two additional incentives in the form of additional revenue and a capex allowance that is above PB Power's assessment of justified capex. Removing these will leave a simpler incentive scheme with less potential for unforeseen consequences, where companies offering well justified capex programmes receive greater rewards for beating their own forecasts than companies with less well justified programmes.

Regulatory asset value and depreciation

We note the proposal to continue using a depreciation adjustment to smooth this part of the cost base. We acknowledge that making sudden changes from one depreciation basis to another can disturb company finances. However, not addressing the issue of how to synchronise the price control and asset depreciation lives merely defers the problem to another period. One of the consequences of this is that consumers end up paying for assets more rapidly than their assumed asset life and charges are higher than they would otherwise be.

Ofgem needs to correct this discrepancy, possibly by establishing a glide path from the current, shortened depreciation profiles to the asset lives used in each company's accounts. Until this is done, shareholders will be benefiting from advance cash flows at the expense of consumers and will not have a true picture of the value of a DNO.

The use of financial indicators, including whether any adjustment should be made for companies with ratios below test levels and, if so, the form it should take

Financial indicators are a useful guide to how well a company is being managed and a weak balance sheet is commonly seen as a sign of poor management. If a DNO does have ratios below the test levels, any adjustment should come from shareholders and that advancing or increasing revenues from customers would provide an inappropriate signal to management and shareholders that Ofgem will bail them out from their poor decisions.

The balance between P0 and X

We note that operating expenditure is expected to reduce by 2% per year and that an assumption of 0.5% improvement a year has been anticipated for improvements in quality of supply. From this, it would seem that an X factor of 1 should be the minimum that is used and that 1.5% could be justified. We would ask Ofgem to expand on why it considers 1% to be appropriate.