

Electricity Distribution Price Control Review

Summary of responses to June 2004 Initial Proposals

September 2004

Summary

This document summarises the responses to the June 2004 Initial Proposals document on the Electricity Distribution Price Control Review. Where appropriate, it also sets out Ofgem's view on the issues raised.

Further details on the issues and work areas are set out in the September 2004 Update document and earlier documents on the Electricity Distribution Price Control Review.

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1. Introduction

- 1.1. The purpose of this document is to outline key points made by respondents to the June 2004 Initial Proposals document on the Electricity Distribution Price Control Review¹.
- 1.2. Where Ofgem announced specific proposals or decisions within the Initial Proposals document, these are highlighted in bold typeface, whereas respondent views are summarised in plain typeface.
- 1.3. This document should be read in conjunction with the document “Electricity Distribution Price Control Review – September Update”, which is being published at the same time as this summary of responses.
- 1.4. Where a respondent raises any points with respect to issues that are not dealt with in the September Update document, the Ofgem view on that point is shown in italics.

¹ Electricity Distribution Price Control Review – Initial Proposals, Ofgem, June 2004, 145/04

2. Form, structure and scope of the revised price controls

Form of the price control

Revenue driver

- 2.1. **Ofgem proposes that for the next price control period there will be no volume driver attached to EHV revenues**
- 2.2. There was general support for the proposal that there would not be a volume driver attached to EHV revenues.
- 2.3. **Ofgem has also reviewed the weightings within the existing revenue driver and proposes revised weightings for each voltage category for each DNO.**
- 2.4. Opinion amongst DNOs was split on this issue. Four DNOs considered that the proposed weightings were suitable, but three queried the rationale for the proposed changes and so were unwilling to commit themselves prior to this clarification.
- 2.5. *As noted by one of the respondents, the current weightings were established in 1989 as part of a much broader exercise that was, in part, designed to avoid instability in prices during the transition to private ownership. Ofgem considers that in light of the subsequent changes to the scope of the distribution businesses, it is opportune to re-examine the appropriateness of these weights. Ofgem is willing to consider submissions of alternative weightings from DNOs, as long as they are accompanied by a robust justification.*

Price index

- 2.6. **Ofgem proposes to use RPI for the next price control period**
- 2.7. There was widespread support for the retention of RPI rather than the introduction of CPI. One respondent noted that the appropriateness of the index for this purpose should be kept under review.

Scope of the price control

Units distributed out of area

- 2.8. **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). Any revenue associated with distributing units out of area will be treated as an excluded service item.**
- 2.9. Four DNOs and one other respondent agreed with this proposal, but one DNO expressed concern on the effect this would have on networks embedded within DNO areas that might be subjected to a large P_0 cut. This respondent proposed the application of a “glidepath” to the relative price of such networks, which it was claimed would be consistent with what has been done in independent gas networks.
- 2.10. *Ofgem has recently consulted on the regulation of IDNOs² and will include the consideration of these responses in any decision it reaches.*

Business rates

- 2.11. **Subject to further review before final proposals, Ofgem is not currently proposing to disallow any rates costs.**
- 2.12. All of the DNOs welcomed this proposal and requested an early confirmation that no such costs would be disallowed. One other respondent expressed disappointment with the proposal, but urged Ofgem to ensure that any allowances in excess of actual rates payments are recovered from DNOs.

Revenue protection

- 2.13. **Ofgem is giving further consideration to the treatment of revenue protection costs. Views are welcome on this issue.**
- 2.14. All of the DNOs and one non-DNO were in favour of revenue protection costs being an excluded service, as they considered that the volume of activity was

primarily driven by supply businesses. One non-DNO was against the proposal on the basis that it would create a clear disincentive for suppliers to share suspicions of illegal abstraction, as they would then become responsible for all investigation costs. It proposed a general charge on suppliers through DUoS to fund revenue protection services so that suppliers would be encouraged to avail of these services.

- 2.15. One other respondent noted that there were interactions between revenue protection services and revenues obtained both through the units distributed revenue driver and the losses incentive, and considered that this needed to be taken into account if revenue protection services were to be treated as an excluded service.
- 2.16. A further response suggested that the issue of revenue protection should be considered as part of the following price control period, but that Ofgem could incentivise DNOs to minimise losses by announcing that revenue protection measures introduced during the coming five year period would be rewarded retrospectively.

Allocation of costs for the incentive mechanisms

- 2.17. **Ofgem proposes to treat all costs on the same basis for the purpose of determining the incentive payment that companies receive for achieving efficiency savings. This will be applied from April 2005.**
- 2.18. Several DNO responses expressed strong opposition to the overall weakening of the incentive regime which results from this proposal, and this was echoed by another respondent who considered that the overall out-performance incentive rates should be no lower than in the current price control. One other respondent was strongly in favour of the equalisation of incentives across all categories of efficiency savings, but did not comment on the lowering of the average incentive rate.
- 2.19. A number of the DNOs considered that the current work on categorisation of costs had sufficient clarity to justify a continuation of the current regime of

² Regulation of Independent Electricity Distribution Network Operators, Ofgem, July 2004, 180/04

differential incentive rates and that any existing deficiencies in the guidelines could be made good before the next price control comes into effect.

Dealing with uncertainty

- 2.20. **Ofgem's initial proposal is that a specific re-opener to the price control for the Traffic Management Act will be reflected in a relevant licence modification and that any costs would be considered in isolation from companies' financial performance under the price control.**
- 2.21. Four DNOs welcomed Ofgem's undertakings with respect to the costs arising from the Traffic Management Bill, but one other respondent stated that there should not be a need for a re-opener. This view was based on the premise that the Act should be in force before the next price control and should have been subject to an impact assessment, which would give sufficient indication of the costs involved for distributors.
- 2.22. **Ofgem's initial proposal is to use a limited re-opener following the consultation on changes to ESQCR at the end of this year and a further re-opener in 2008 to consider costs associated with line clearance work (ie a 2-stage specific re-opener), and that any costs would be considered in isolation from companies' financial performance under the price control.**
- 2.23. Again, four DNOs were in favour of this proposal, although two of these considered that the second re-opener should be brought forward to be as soon as DNOs begin to incur costs in relation to ESQCR. One other respondent suggested that ESQCR might be a suitable case for use of a re-opener, although it stated that the comparative uncertainty of the costs involved was no greater than that in relation to a typical capex program.
- 2.24. While supporting Ofgem's proposals on the Traffic Management Act and ESQCR, the majority of distributors still expressed a clear preference for the adoption of the more general uncertainty mechanism as proposed by the Electricity Networks Association (ENA). One other respondent was strongly opposed to the adoption of a general uncertainty mechanism, on the grounds that the current uncertainties faced by distributors are no greater than those consumers have to cope with in respect of DNOs' future actions.

- 2.25. One DNO stated that it had included other areas of cost uncertainty in its FBPQ submission which should be allowed at an average cost level, with companies absorbing the risk of fluctuations from that level. Other areas of cost uncertainty that were specifically identified for potential re-openers were changes to the corporation tax system, IT changes as a result of the Customer Transfer Project and the move by BT to IP technology.

Losses

Overall incentive rate

- 2.26. **Ofgem proposes to use the mid-point of the range, ie £48/MWh (in 2004/05 prices), for the duration of the price control. Views are welcomed on this issue.**
- 2.27. Opinion amongst the DNOs was split in relation to the value being proposed for the incentive. Three DNOs gave broad support to the proposal, while three others queried the validity of calculations regarding various components of the rate. One also stated that the inclusion of EHV within the calculation would result in increased exposure to short-term risk which was outside of its control.
- 2.28. Two non-DNOs generally supported the principle behind the losses incentive, but one of these plus another respondent queried the levels of various components underpinning the incentive rate.
- 2.29. Three DNOs highlighted that the criteria for allowing capital expenditure on low losses equipment to enter the RAV needs to be more clearly defined, while two other respondents considered that DNOs would be rewarded twice for investment in loss reducing assets (through the return on RAV and the losses incentive) and Ofgem should take this into account. One suggestion was that this could be factored in through the adoption of an asymmetric incentive rate, with increases in losses being penalised at a rate greater than the reward for loss reductions.
- 2.30. *Having considered the views of respondents, Ofgem is minded to retain the losses incentive rate and scope as laid out in the Initial Proposals. The issue of*

criteria for allowing expenditure to enter the RAV will be set out in the Final Proposals.

Losses target values

- 2.31. **Table 3.2 set out Ofgem's initial view on the losses target for each DNO.**
- 2.32. One DNO stated that it had suggested specific adjustments to its target value to take account of inconsistencies in the historical pattern of reported losses. Another DNO stated that the target should be based on a simple 10-year average and that the use of weighting affected it in a materially significant manner.
- 2.33. Another respondent considered that it might be appropriate to use a 10-year trend to set the target, since levels of losses appeared to be generally falling. It was concerned that the use of a simple average as against the trend would give a windfall benefit to DNOs at the start of the next price control for no additional effort in reducing losses.
- 2.34. One respondent expressed concern that the proposed mechanism would not achieve a sustained reduction in losses, and so the scheme should revert to adjusting the target level of losses as originally proposed.
- 2.35. **Ofgem proposes that the minimum level of the loss adjustment factor (LAF) should be set to 0.997**
- 2.36. Two DNOs proposed that the minimum LAF should be set at one, while another stated that it should be one for a particular geographic region within its distribution area. A further DNO stated that the LAF should be set such that there is still some expectation for the DNO of an overall benefit from DG schemes that increase losses. However, another respondent expressed disappointment that DNOs were to be protected from the potential adverse effects of remote DG but were benefiting in full from the gains arising from non-remote DG.
- 2.37. *Ofgem is not minded to change its view on this issue, as it considers that the logic underpinning the original proposal is still valid.*

Other losses-related issues

- 2.38. One respondent proposed the adoption of an alternative means of metering electricity consumption which, it was claimed, would produce a more accurate reconciliation of consumption and help to segregate theft of electricity from technical losses.

3. Metering

Meter Asset Provision (MAP)

- 3.1. **The June document indicated that Ofgem was minded to introduce a price cap for the provision of certain types of meters. In addition, a proposed licence condition would require DNOs to use a non-discriminatory approach to calculate price capped and non-price capped charges in relation to meters provided in accordance with SLC 36-36C of the distribution licence.**
- 3.2. One non-DNO respondent and all but one of the DNOs expressed support for the principle of a price cap combined with a non-discrimination obligation. However, several DNOs and one non-DNO respondent asked for further details of the calculation methodology for the actual price caps.
- 3.3. Concern was expressed by one non-DNO respondent about the indicative rise in Pre-Payment Meter (PPM) MAP charges, particularly given the proposed fall in Standard Credit (SC) MAP charges. They noted that PPMs are disproportionately used by vulnerable customers who often do not choose to use this meter type. This respondent disagreed with Ofgem's assertions that supplier innovation may reduce overall PPM charges and that DNOs may not price up to the cap.
- 3.4. This non-DNO respondent favoured an equal percentage reduction in PPM and SC charges and a further Ofgem consultation on whether the level of MAP charges for SC and PPM should be equalised.
- 3.5. The spread of published MAP price cap levels surprised some respondents, with two DNOs supporting the use of a standard price cap across all DNOs.
- 3.6. One DNO and a non-DNO respondent stated that the indicative MAP price caps appear to be too low to stimulate entry. They suggested that using the depreciated replacement cost means that the price caps reflect long term average asset costs and will not allow an entrant to obtain the full return on a new meter.
- 3.7. The non-DNO respondent suggested methods of increasing the price cap and asked Ofgem to consider the necessary level and duration of headroom.

- 3.8. A non-DNO respondent was concerned about the incentive on DNOs to allocate costs to distribution rather than to the metering price control. They stated that if DNOs are allowed to increase their metering price control charges, there should be an equal and opposite change in their distribution price control.
- 3.9. Several DNOs supported the introduction of a mechanism to recover costs stranded by the combination of premature asset removal and loss of market share. Four DNOs supported the use of termination charges. Other proposed mechanisms included reducing the expected asset life or employing a higher cost of capital. However, a non-DNO stated that it would not be appropriate to increase the price cap by using a higher rate of depreciation.
- 3.10. One DNO was disappointed that the MAP price caps would not rise as DNO market share declined.
- 3.11. One DNO asked for clarification of the definition used to determine the coverage of the price cap.

Meter Operation (MOp)

- 3.12. **In the June document, Ofgem proposed using an average revenue cap limiting the revenues derived from providing MOp services in accordance with SLC 36-36C of the distribution licence by an amount related to the number of meters provided.**
- 3.13. Most DNOs disagreed with the use of the number of metering points as the revenue driver because they felt that it does not accurately reflect the significant fluctuations in annual MOp work volumes and costs.
- 3.14. Several DNOs highlighted other cost drivers, such as the number of visits. However, some DNO respondents stated that it would be very difficult to construct a robust price control using these activities as revenue drivers.
- 3.15. Four DNOs supported extending the form and structure of the MAP price control for MOp services.
- 3.16. One DNO suggested that DNOs should propose MOp charges for 2005/6 and 2006/7 with Ofgem having oversight of these charges. DNOs would be required

to justify any proposed increase in charges and would have the scope to amend the charges in exceptional circumstances.

- 3.17. Several DNOs commented that the MOp costs in Table 3.4 were misleading as they only covered opex and therefore reflected differences in historical capitalisation policy across DNOs. They stated that the figures are not comparable and should not be used to set a price control.
- 3.18. Two DNOs supported the use of higher margins in setting the cap on revenue from MOp services.
- 3.19. One DNO asked for caution in the use of contract rates from DNOs who have outsourced or sold metering businesses.
- 3.20. **Ofgem sought views on whether DNOs should recover the fixed costs associated with lost market share through their remaining MOp market share.**
- 3.21. Three DNOs favoured using an adjustment mechanism to increase the overhead cost recovery element of the price control as DNO market share declines.
- 3.22. Other DNOs supported the recovery of fixed costs through DUoS charges rather than across remaining MOp customers.

Associated changes to standard licence conditions 36-36C

- 3.23. **The June document sought views of interested parties on the proposed approach to defining a meter and basic service.**
- 3.24. Four DNOs and one non-DNO respondent expressed support for the proposed approach. However, two of these DNOs wanted to see detailed proposals.
- 3.25. Two DNOs favoured defining basic services with reference to a date after the introduction of REMA on 1 June 2003.
- 3.26. One DNO respondent stated that the use of standardised definition of basic services across all DNOs would facilitate inter-regional price and service comparisons.

- 3.27. A clear definition of basic services and service levels was requested as soon as possible by one DNO.
- 3.28. **In the June document, Ofgem proposed modifying the obligation to provide metering services. This would mean that it would not apply to suppliers in relation to meter points at which they have decided to take services from metering services providers other than the DNO.**
- 3.29. Three DNOs and one non-DNO respondent expressed support for the proposals.
- 3.30. Two DNO respondents highlighted the significance of the precise definition of deappointment. They stated that it may be appropriate to use a floor threshold for customer numbers below which a DNO would be relieved of all obligations for that supplier.
- 3.31. **In the June document, Ofgem proposed to switch off with effect from 1 April 2007 the SLC 36-36C provisions related to metering operation and provision of new metering assets.**
- 3.32. Explicit support was expressed by a number of DNOs and one non-DNO respondent. One DNO requested an annual competitive review to assess whether or not obligations could be lifted earlier.
- 3.33. Three DNOs and one non-DNO respondent asked for clarification about the definition of ongoing obligations, particularly whether these would refer to physical assets or existing contracts.

Other issues

- 3.34. Concerns were raised by the DNOs about the scope, accuracy and sufficiency of the information published by Ofgem on data, methodology and proposals – this hinders companies in validating and challenging proposals. A non-DNO respondent expressed disappointment with the lack of detailed information on MOp charges in particular. One DNO asked for the provision of a detailed audit trail in the September paper.
- 3.35. DNOs noted that the progress on the metering price control was slower than in other areas and that there was much to be done to meet an increasingly tight

timetable. Some DNO respondents stated that the slow progress has led to uncertainty about ongoing metering revenue, particularly for MOp services, and difficulties in tendering and negotiating with service providers.

- 3.36. A non-DNO respondent stated that suppliers and other interested parties, should, in addition to DNOs, have the chance to comment on detailed MOp proposals before the final proposals are issued.
- 3.37. Another issue raised by a non-DNO respondent was the need for clarification of the definition of metering assets in order to ensure that ownership rights are clearly understood.
- 3.38. A DNO asked for an explanation from Ofgem of how competition would operate in the long-term if suppliers contract for metering services with alternative providers, which may be unlicensed entities.
- 3.39. A non-DNO respondent stated that most suppliers had still not contracted out metering services to commercial operators. They also highlighted that developments in electricity metering competition could affect gas metering competition.

4. Quality of service and other outputs

Summary of the results from the Customer Survey

- 4.1. **The results of the customer survey point towards a degree of willingness to pay which could be reflected in stronger incentives for improvements in quality of supply, provision of information and restoration of supplies following severe weather events.**
- 4.2. Three DNOs agreed with Ofgem's conclusion that the customer survey shows that customers do value the key elements of service that are measured and targeted through the existing IIP incentive scheme such as restoration of supply. However, they felt that the results demonstrated that customers are also willing to pay for improvements in other areas such as resilience and undergrounding. Two other respondents also agreed that the results supported further investment in undergrounding.
- 4.3. Five DNOs were of the view that Ofgem had not taken sufficient account of the customer survey when setting expenditure allowances and that these allowances are too low. One of these respondents noted that while Ofgem has made an explicit opex allowance for restoration improvements, Ofgem should recognise that capex solutions, such as remote control and automated restoration, represent a valid alternative.
- 4.4. One respondent was concerned that the methodology of the willingness to pay survey was biased against rural/worst served customers and that the interpretation of the results was skewed in favour of restoration incentives.

Revenue Exposure to the quality of service incentives

- 4.5. **The customer survey and other evidence of consumers' priorities suggest that the previous cap on the level of revenue exposed to quality of service performance should be increased. Table 4.1 of the Initial Proposals paper set out Ofgem's proposals for the amount of revenue to expose to quality of service.**

- 4.6. There was some support for increasing revenue exposure to the quality of service incentives as well as limiting the downside risk to 4 per cent of revenue. However, three respondents considered that the proposed cap of 4 per cent is excessive when considered against a background where investment plans have been cut, challenging efficiency targets have been set and revenue exposure in other areas has been increased. One DNO felt that all standards of performance should be taken into account in assessing the levels of penalties against the overall cap while another felt that a two per cent cap would be more reasonable.
- 4.7. One DNO felt that it was difficult to quantify the impact of the increased revenue exposure at this stage because there not a robust link between the base case and quality of supply allowances and the targets and the detail of the exceptional event mechanism had yet to be defined. Another DNO suggested that by reducing the quality of supply allowances compared to the previous price control, Ofgem is offsetting the potential for increased rewards from higher revenue exposure and incentive rates.
- 4.8. *The incentives for quality of service that were introduced under the IIP have worked well and there is some evidence that consumers are willing to pay more for improved service. The targets that underpin these incentives and which companies will be expected to deliver have also been reset – using an improved method based on detailed disaggregated data supplied by the DNOs. The incentives and arrangements for restoring supplies following severe weather have also been clarified. Ofgem therefore considers it appropriate to strengthen the incentives for quality of service.*

Standards of performance

Severe Weather Standard

- 4.9. **There will be separate standards for restoration under “normal weather” conditions and severe weather set out in a new licence condition (see section on storm payment arrangements). The existing 18-hour threshold and levels of compensation will be retained under normal weather conditions.**
- 4.10. Most respondents who commented on the issue supported Ofgem’s proposal to separate the supply restoration standard into ‘normal’ and ‘severe’ weather

standards, although one DNO suggested that a degree of flexibility needed to be retained as the thresholds for severe weather were based on assumptions which had not yet fully been tested. One DNO indicated its support for the removal of the materiality threshold from the storms arrangements whilst another agreed with the retention of the 18 hour standard for 'normal' weather.

Semi-automatic payments

- 4.11. **The consumer research results indicate that there is a low awareness of the standards of performance and that companies have an incentive to avoid making consumers aware that they are entitled to payment for a failure. This incentive should be removed. This will be achieved by ensuring that the penalty on companies is the same, whether or not the consumer claims. Where the DNOs do not pay the consumer, they will face an equivalent reduction in price control revenue for a failure under the 18 hour restoration standard or severe weather arrangements.**
- 4.12. Two DNOs expressed support for semi automatic payments, but during 'normal' weather conditions only. Other respondents generally supported this initiative.
- 4.13. The majority of DNOs did not agree with Ofgem's intention to reduce price controlled revenue where payments to customers are not made, stating that this was unreasonable and should only be the case where companies cannot demonstrate that they have made reasonable efforts to inform customers of their rights to compensation. However, other respondents were generally supportive of this proposal. One non DNO respondent suggested that the scheme needed to be strengthened by including any administration cost saved by not paying out compensation to customers in the adjustment to revenue.
- 4.14. *This issue was addressed in paragraphs 4.17 and 4.18 of the June Initial Proposals document.*

Route for payments to customers

- 4.15. **Ofgem proposes that DNOs should have the option of making payments directly to consumers, although there should still be the alternative of making payments via suppliers where this is not practicable.**

- 4.16. There was general support for this proposal. However one DNO suggested that further consideration should be given to the costs and benefits of implementing such a scheme.
- 4.17. *This issue was addressed in paragraph 4.19 of the June Initial Proposals document.*

Compensation for HV Connected Business Consumers

- 4.18. **Ofgem proposes to retain the existing arrangements.**
- 4.19. DNOs indicated support for maintaining the current arrangements. However, two other respondents were disappointed that the existing arrangements were to be retained, believing that this would perpetuate inequalities between customers. One respondent felt that increased compensation levels would have improved incentives.
- 4.20. *This issue was addressed in paragraph 4.14 of the June Initial Proposals document.*

Overall Standards of Performance

- 4.21. **Ofgem proposes to remove the Overall Standards on DNOs from 1 April 2005 and these will be replaced by similar reporting requirements under the RIGs.**
- 4.22. DNOs broadly expressed support for the removal of the Overall Standards and, where appropriate, their replacement with similar reporting requirements under the RIGs. One DNO highlighted that, given the additional reporting requirements including disaggregated interruption data, it would be necessary to extend the data timescales prescribed in the licence by a month in order to maintain data quality.
- 4.23. *This issue was addressed in paragraph 4.22 of the June Initial Proposals document.*

Reviewing IIP

Form of the incentive scheme

- 4.24. **Ofgem proposes an incentive scheme for interruptions with symmetric annual rewards and penalties depending on performance against their targets. The impact of severe weather events will be fully excluded from the scheme.**
- 4.25. The majority of respondents were in favour of an interruption scheme with symmetric annual rewards and penalties, although three of the DNOs felt that true impact of the scheme is asymmetric as the proposed targets mean that there is less scope for rewards for outperformance than penalties for underperformance. Two of the respondents suggested that all exceptional events should be excluded and not just those events relating to severe weather. One DNO argued that the next price control should properly provide for genuine exceptional events that are outside of the DNOs' control, whilst another suggested that an event which triggers the severe weather threshold in one company should trigger exemptions for all affected companies for the relevant period.
- 4.26. One non DNO noted the importance of considering wider commercial and safety implications when reviewing incentives whilst another advocated basing incentives or an element of incentives on energy unsupplied. A small number of respondents felt that incentives on interruptions were inadequate and were concerned that the proposed incentives placed insufficient attention on longer-term issues.
- 4.27. *Ofgem has set out a revised process for "one-off" exceptional events in the September update paper. Ofgem considers that it is important that such events continue to be regulated and that companies are incentivised to take appropriate actions both to reduce the chances of such events occurring and to minimise their impact.*
- 4.28. **Ofgem proposes to increase the revenue exposed to 1.2 per cent on the number of customers interrupted (CI) and 1.8 per cent on the number of minutes lost per customer (CML).**

- 4.29. There were mixed views on this issue. One DNO believed that any increases should not take effect until concerns over target setting and operation of the scheme had been resolved. Another supported the increases.
- 4.30. *This issue is addressed in paragraph 4.8 above.*
- 4.31. **Ofgem proposes applying a 50 per cent weighting to planned outages within the interruptions incentive scheme.**
- 4.32. Again responses were mixed on this issue. One DNO welcomed Ofgem's acceptance of the different impact of planned and unplanned interruptions on customers whereas two other DNOs opposed the weighting. These DNOs were concerned with possible perverse incentives to reallocate fault repair work to 'planned' schedules. Other non-DNOs raised similar concerns.

Setting Targets – Setting CI

- 4.33. **Ofgem has applied a 0.5 per cent per annum improvement in the benchmarks for the number of customers interrupted through to 2020 to reflect developments in technology and best practice.**
- 4.34. **If a company is already outperforming the 2020 benchmark calculated, the proposed targets are set in line with current performance. If a company's average performance is worse than its 2020 benchmark the proposed targets are set based on catch-up of 40 per cent of the performance gap by 2010.**
- 4.35. There was some support for the broad process of using disaggregated performance data to set longer-term targets. However, there were a range of concerns with detailed aspects of the methodology for setting the 2010 targets and concerns that the levels of allowances to meet the targets were too low.
- 4.36. One DNO was concerned at how the target setting process had been superimposed on the disaggregation work, arguing that there was incomplete understanding of the data and the degree of variability between DNOs. Another DNO expressed concern that the data used for the benchmarking was not truly reflective of underlying performance of the networks.

- 4.37. One DNO suggested that further justification was needed for the '0.5 per cent per annum improvement'. It suggested that this was a significant number based on a general assumption that further improvement is possible. It also suggested that further analysis was needed to support the 40 per cent catch-up for companies who are currently underperforming their benchmarks.
- 4.38. There was also some concern that the analysis is only based on three years of RIGs compliant data and that by including unit-protected circuits it generates unrealistic benchmarks for some companies.
- 4.39. Several DNOs suggested that tightening targets to current performance actual penalises companies who are performing better than the benchmarks through management effort and expenditure. They suggested that the cost assessment work (and hence allowances) did not recognise that companies outperforming the benchmark must already have higher costs than if they were falling short of the benchmark. One DNO noted that DNOs with a CML target tighter than the benchmark have been given an annual cash reward and that for consistency of treatment between CI and CML targets, the same process should be applied to CIs. Another suggested that targets need to be directly and transparently related to the investment required to deliver performance.
- 4.40. Some concern was also raised over the calculation of forecasts for planned interruptions.
- 4.41. A number of other respondents suggested that the 2010 targets should be more challenging as this is an area where consumers should receive sustained improvements in performance. One respondent argued that the targets should be based on individual DNO's performance rather than average performance and did not support the additional allowances proposed. Another suggested that the use of trend performance would be better than average performance in setting the starting point for the targets.

Setting CML

- 4.42. **Ofgem proposes to apply the benchmarks for restoration times to the targeted number of interruptions to derive the 2010 targets for customer minutes lost.**

- 4.43. In their main responses to the June price control document and subsequent discussions most of the DNOs raised issues with Ofgem's methodology for setting CML targets. A number of DNOs argued that this had departed from the approach discussed in the quality of supply working groups and the use of upper quartiles had led to overly onerous targets.
- 4.44. A number of DNOs suggested that the methodology of applying average restoration times (CML/CI) to CI targets is flawed as there is an inter-relationship between CI and CML/CI. For example, they note that additional protection zones reduce CI but increase average restoration times (CML per CI).
- 4.45. Two DNOs suggested that there was too much variation in average restoration times (CML/CI) for Ofgem's benchmarks to be credible. They suggested that some of this variance must relate to other factors that have not been incorporated in the disaggregation model. Other DNOs suggested that factors such as LV Consac had not been adequately addressed and that Ofgem had not carried out sufficient benchmarking analysis at LV.
- 4.46. A number of alternative approaches were suggested for setting the CML targets such as using the same approach as for CI or applying the upper quartile or average restoration times to benchmark CI performance for each DNO.
- 4.47. Other non DNOs respondents proposed that targets should be more rigorous provided that sufficient expenditure was made available and that the present proposals were heavily weighted towards cost minimisation rather than a reduction in customer minutes lost. One respondent highlighted alternative practical measures to reduce CMLs such as temporary generation.
- 4.48. **Ofgem also intends to include a cost allowance for operational improvements to enable companies to reduce average restoration times. This allowance is based on a specified amount per fault (just over £200) multiplied by a benchmark level of faults for each company.**
- 4.49. The majority of DNOs were concerned with Ofgem's methodology for calculating quality of supply opex allowances and its application across all DNOs. One DNO argued that it was neither appropriate nor robust to use a single figure as a 'benchmark' cost for all DNOs.

- 4.50. A number of DNOs suggested that further consultation should be undertaken to determine an appropriate value for each DNO, taking into account their specific circumstances.
- 4.51. A number of DNOs also stated that opex allowances were insufficient and were not the only solution to achieving improvements in restoration. They argued that Ofgem should also recognise that capex solutions, such as remote control and automated restoration, represent a valid alternative.

Rewarding Best Practice

- 4.52. **Ofgem proposes that WPD South West and WPD South Wales should be each given an additional reward of 1 per cent of revenue per annum.**
- 4.53. Five respondents were concerned with Ofgem's proposals in this area. One DNO suggested that an ex post reward represented a windfall gain for the company with no effect on incentives and another DNO argued that the level of the reward was disproportionate to the actual level of performance relative to that of other companies.
- 4.54. Other respondents were supportive of the principle of a reward for good performance, but argued that the areas under consideration should be communicated in advance to all participants and that CML performance should not be the only measure of performance taken into account. One non DNO respondent suggested that the asymmetric format of this proposal was inappropriate, arguing that where frontier performers received increased rates of return, poor performers should be penalised.
- 4.55. *Ofgem considers it appropriate for WPD to be given a reward for best practice for supply restoration as its level of performance has been used to benefit all customers through the benchmarking methodology for setting CML targets for the next price control period.*

Setting incentive rates

- 4.56. **Ofgem proposes to use the incentive rates derived from the top-down approach. Ofgem has assumed 25 per cent bands either side of the target for**

the number of customers interrupted and 30 per cent bands either side of the target for customer minutes lost.

- 4.57. Several DNOs supported Ofgem's broad top-down approach to setting incentive rates, while one non DNO respondent suggested that a combination of the bottom-up and top-down approaches would be a more robust way of setting incentive rates.
- 4.58. Several respondents had concerns with the proposed width of the performance bands used in setting incentive rates, suggesting that 30 per cent improvements in performance were unrealistic. One DNO suggested that CI band should be reduced to 15 per cent and the CML band to 20 per cent. Another suggested that the width of the performance bands should be asymmetric around the targets as there was less scope for outperformance than underperformance. One respondent felt that the existing performance bands should be retained and another argued that there was a large mismatch between the proposed interruption incentive rates and what customers had indicated they were willing to pay for improvements in the customer survey.
- 4.59. *Ofgem has updated the interruption incentive rates to reflect changes in targets and costs allowances. In deciding the appropriate width of the incentive bands Ofgem has balanced the rewards for companies to outperform their targets against the risk of companies failing to meet the targets.*

Audits and Adjusting Data for Inaccuracy

- 4.60. **Ofgem proposes to adjust each DNO's data to take into account any inaccuracy identified by the audit. Ofgem also proposes to tighten the overall accuracy requirements from 95 to 97 per cent over the next price control period.**
- 4.61. Four DNOs indicated support for streamlining the audit process for the next price control whilst maintaining the improvements in accuracy. One DNO suggested that a more streamlined approach could be for DNO to conduct their own audits with external auditors reviewing a proportion of the audit sample.
- 4.62. All but one of the DNOs opposed Ofgem's proposal to tighten the overall accuracy requirements to 97 per cent in the next price control, arguing that the

costs would outweigh the benefits involved. Other respondents supported the proposal. The DNOs were also concerned with the idea of adjusting the interruption data to take into account any inaccuracies identified by the audit. They felt that this was inappropriate given the size of the audit sample.

Frontier performance

- 4.63. **Ofgem proposes that the top 4 performers on CI will be eligible to take part in the CI element of the out performance scheme. The top 4 performers on CML/CI will be eligible to take part in the CML element of the out performance scheme.**
- 4.64. There was general support for extending the 'outperformance' reward in the existing IIP scheme to frontier performers. However, DNOs suggested a number of changes to the proposed mechanism. One DNO suggested that frontier performance should be assessed against the existing IIP targets, another felt that frontier performer on CI should be allowed to take part in the CML scheme and vice-versa. One DNO suggested that further details and clarity of the mechanism would be required before judging the scheme's practical merits.
- 4.65. One DNO argued that frontier performance should be recognised with either a specific revenue allowance or by setting a less challenging target in relation to benchmark performance.
- 4.66. *This is addressed in paragraphs 4.54 and 4.55 of the June Initial Proposals document. Ofgem's disaggregation and benchmarking analysis using an average of 2002/3 and 2003/4 data shows Manweb, EDF(LPN), Hydro and UU to be the top 4 performers on CI. WPD (South-Wales), WPD (South-West), EDF (EPN) and Southern are shown to be the top 4 performers on CML/CI.*

Storms arrangements

- 4.67. **Ofgem proposes to retain similar interim arrangements for consumers in the next price control period but with some key amendments to improve the existing arrangements. Additional detail on the changes was set out in an accompanying paper on losses and quality of service.**

- 4.68. A number of companies expressed concern that the proposed gate for very large events was too high; with some DNOs providing examples of previous large scale events which were in percentage terms much smaller than the gate and yet had a major impact on the distribution system. A number of DNOs suggested retaining the current threshold of 25 per cent for the gate as currently set out in the Interim Arrangements. Two other respondents agreed with Ofgem's proposals. One DNO also highlighted its concern that the risk of double jeopardy remains between the storm arrangements and interruptions incentive scheme.
- 4.69. Four DNOs expressed concern over raising the cap on revenue exposure to 2 per cent, with one DNO stating that this was an excessive level of exposure to events which are largely outside of a company's control.
- 4.70. The majority of DNO responses highlighted concern with the proposed allowances, arguing that the allowances put forward by Ofgem are insufficient to cover the cost of fault repairs, costs of resilience work or storm insurance. One DNO suggested that additional work was required to explain the assumptions which underpin the proposed 'per customer allowances'. Other respondents had mixed views on this issue, with two suggesting it was inappropriate to provide additional allowances in this area. One non DNO respondent commented that they did not believe that storm insurance was a realistic alternative.

Incentives for the speed and quality of telephone response

- 4.71. **Ofgem proposes to simplify the arrangements, with companies subject to a sliding-scale penalty if annual performance deteriorates below the current minimum average performance level of 4.1. The proposals include a small reward of 0.05 per cent of revenue for those companies with annual mean scores higher than 4.5.**
- 4.72. **Ofgem proposes to retain the existing assessed survey questions, but incorporate consumer satisfaction with the speed of telephone response.**

- 4.73. **Ofgem intends to develop a way of supplementing the annual incentive with an incentive relating to performance during exceptional events. No revenue will be exposed in the first two years of the scheme but there should be equal rewards and penalties from April 2007 with 0.25 per cent of revenue exposed.**
- 4.74. There was some support for a move towards an absolute scheme based on the DNO's own performance. Respondents expressed general support for the inclusion of automated messaging in the survey, but there was some concern over outstanding issues with the practical development and potential costs of implementation of such arrangements.
- 4.75. Three DNOs expressed concern over the proposed changes to the form of the scheme, suggesting that any incentives should remain symmetrical with one DNO stating that reducing the incentive will increase the risk that performance will slip. One DNO argued specifically against the proposed increased risk exposure of the scheme and stated that it may divert resources away from other areas where improvements are required. A small number of DNOs also suggested that the revised scheme would penalise historical investment made in telephony systems.
- 4.76. Some concern was expressed by DNOs over changes to the content and scope of the survey having a subsequent impact on performance relative to the ceiling and floor of the backstop scheme.
- 4.77. There were mixed views on the inclusion of the speed of telephone response in the survey of customer satisfaction. A small number of respondents supported this proposal. Another respondent argued that it should be measured objectively and incentivised separately from the customer survey.
- 4.78. The majority of respondents supported assessment of performance during exceptional events and supported Ofgem's intention to develop this idea further before exposing revenue. However, one DNO argued that an additional incentive relating to performance during exceptional events was unnecessary; stating that sufficient external scrutiny from the media, customers and shareholders existed as pressure on companies to perform well. Another DNO did not support this proposal as it felt that the quality of telephone response in storm conditions cannot be effectively measured.

- 4.79. *Ofgem proposes to retain the existing attributes for the customer survey of telephone response, with the addition of a question on customer satisfaction with the speed of telephone response. Performance on this attribute has been measured on a trial basis since April 2004 and is similar to other assessed attributes.*
- 4.80. *Ofgem will continue to monitor the results of the customer survey over the coming months and consider whether it is appropriate to revise the thresholds for the scheme in final proposals.*
- 4.81. *Ofgem intends to work with the DNOs over the period up to 2007 to determine whether it will be practicable to include satisfaction with automated messaging within the telephony survey from April 2007, including whether it is possible to overcome technical hurdles.*

Environmental Reporting

- 4.82. **Reporting requirements will be introduced in the areas proposed under the RIGs but will not be subject to financial incentives in this price control period.**
- 4.83. Opinion was divided on the issue of environmental reporting; with some DNOs supporting Ofgem's recognition of environmental responsibilities and monitoring of such areas, but other DNO respondents arguing that this would be a duplication of effort and agency responsibilities. Non DNO respondents were supportive of Ofgem's proposals.
- 4.84. All respondents to the issue of financial incentives relating to environmental reporting agreed that these would be inappropriate at this time.
- 4.85. *Ofgem has a statutory duty to have regard to the effect of the distribution of electricity on the environment. This requires a good understanding of the environmental impacts of these activities and reporting is an important step in understanding environmental impacts. While not wishing to cut across the role of the environmental regulators, Ofgem considers that it is appropriate for DNOs to report, through the price control framework, on a small number of environmental indicators.*

4.86. *As set out in the most recent consultation of the RIGs, the reporting measures will be:*

Table 4.1 Environmental reporting measures

Performance indicator	Reportable measures
Loss of SF6	Weight of SF6 in service (kg) Weight of SF6 lost (ie, used for top-ups) (kg)
Loss of insulating fluid	Volume of fluid used to top-up cables (l) Total length of fluid-filled cable (km of cable) Number of reportable incidents Number of prosecutions
General Environmental Management	% of activities covered by a certified Environmental Management System (EMS) scheme

4.87. *To support the reporting of these indicators, DNOs are also asked to provide a supporting narrative including:*

- *for 2006/07 onwards, discussion of any emerging trends in the environmental data and areas of trade-off in performance*
- *further details of any reportable incidents or prosecutions;*
- *details of any EMS accredited under ISO or other recognised accreditation scheme.*

4.88. *Ofgem continues to take an interest in Schedule 9 matters and DNOs are also encouraged to send Ofgem copies of their Schedule 9 statements, for instance, after a review or update.*

Discretionary Reward

- 4.89. **Ofgem propose the introduction of a separately assessed discretionary reward which would cover areas of performance not addressed by other arrangements. The scheme will reward good practice, but there is no intention to penalise companies. Ofgem proposes to assess performance using a two-part annual survey. One part will request information from the DNOs on current practices and the other will be focused on key stakeholders such as social services, energywatch and other agencies.**
- 4.90. The majority of respondents on this issue generally supported the principle of introducing a discretionary reward.
- 4.91. However, two DNOs outlined that the measurement criteria must be defined in advance in order to ensure robust measurement, whilst another suggested that the mechanisms to support the proposed reward may become unnecessarily elaborate. One DNO suggested that the assessment process should be independent of Ofgem. A small number of respondents suggested that the scope of the award should also be extended to include aspects of environmental good practice and safety performance.
- 4.92. *The purpose of the discretionary reward scheme is to encourage best practice in areas of service that cannot easily be measured or incentivised through other more mechanistic incentive schemes such as wider aspects of communications, corporate social responsibility and the service to priority customers. Ofgem is giving further thought to the areas that should be covered by the scheme and the appropriate composition of the panel that will consider the allocation of the reward. This work will continue beyond Final Proposals in November.*

Resilience and worst-served customer

- 4.93. **A number of companies have put forward forecasts for significant costs for improvements in quality of service specifically targeted at rural/worst-served consumers. In the light of the survey results, which show that there is little willingness of other consumers to fund improvements in these areas, Ofgem**

has not included any additional allowance. Ofgem will consider this further if DNOs demonstrate that their proposals deliver net benefits to consumers.

- 4.94. Some DNOs were of the opinion that Ofgem had given insufficient consideration to the DNO Quality of Supply cases.

Undergrounding in Areas of Outstanding Natural Beauty

- 4.95. **It is unclear whether significant expenditure on under grounding would be consistent with the Social and Environmental Guidance provided to Ofgem by the Secretary of State for Trade and Industry. The Initial Proposals therefore contain no allowance for under grounding for visual amenity reasons.**
- 4.96. A number of respondents argued that Ofgem is the most relevant agency to influence undergrounding and further that the proposals indicate a lack of understanding of its own and DNOs' statutory duties. One DNO argued that the consumer research highlighted consumer concerns over the issue of overhead lines in designated areas and were disappointed by the lack of proposals for additional expenditure in Ofgem's latest proposals.
- 4.97. The opinion on undergrounding amongst DNO respondents was divided; with some agreeing that cost allowances and wholesale undergrounding could not be justified whilst others suggested that undergrounding for environmental reasons should be considered. Two DNOs suggested that undergrounding should be considered further as part of ongoing development of the proposals. One DNO thought that it should be possible to establish a level of investment consistent with the results from the consumer survey in the same manner as had been done for other areas of quality of supply.
- 4.98. The majority of other respondents on this issue were disappointed with the lack of proposed action and investment in this area, with only one supporting Ofgem's proposals not to allow additional costs given other significant increases in DNOs' investment in the next price control period. One respondent also suggested that Ofgem's argument of consumers paying for benefits that go to

other consumers is flawed, as each DNO region will have protected landscapes and as such all consumers would pay for some protected landscape.

5. Distributed generation, innovation funding and registered power zones

Distributed generation

DG Incentive – general

- 5.1. Some DNOs still consider the incentive rate too low, or its application to only the connected DG presenting unjustified risks to the DNOs.
- 5.2. On profiling the pass-through revenue, most of DNOs preferred a RAV approach, due to the potential complexity for operating two different approaches between demand and generation, especially in cases of assets transfer from generation to demand.
- 5.3. The proposed operation and maintenance (O&M) rate was supported by one DNO, but another argued for it to be higher for one of its own areas.

Network availability incentive

- 5.4. DNOs continued to have concerns with the proposed mechanism of rebate to DG for network unavailability. They generally preferred using a simpler alternative based on the guaranteed service standards type approach. Similar points have also been made in the process of developing the new distribution charging methodology, of which the detailed arrangements for rebates form a part.
- 5.5. *Ofgem agrees that the originally proposed scheme could incur disproportionate administration costs for LV connected DG, and hence considers that the guaranteed service standards type approach is more appropriate. However, for DG connected to HV and EHV, Ofgem remains convinced of the merit of the proposed rebate scheme which is based on a default rebate rate of £0.002/kWh and contains scope for bilateral negotiation on relevant parameters.*

Treatment of strategic investment

- 5.6. One DNO respondent reiterated its support for no specific allowance being provided for advance strategic network investment. However, another continued to believe that the lack of special allowance would delay the investment to accommodate DG.

Treatment of high-cost projects

- 5.7. Some DNOs still considered the unit cost threshold of £200/kW should be lowered. With one exception, DNOs wanted the £100k total cost threshold removed as they saw it adding to the complexity and diluting the effect of the special treatment. A number of them DNOs also pointed out that the incremental shared costs moved to connection charges should not be included in the adjustment for connection boundary change so as not to reduce the beneficial effect of the special treatment.
- 5.8. One respondent representing network users' interests considered it inappropriate to protect the DNOs from the risks of high-cost projects yet at the same time allowing them to keep the windfall from cheaper projects.

Applying DG incentive on micro-generation

- 5.9. Some DNOs and energywatch welcomed the decision that micro-generation will be included in the DG incentive arrangements. One DNO suggested using a different incentive rate to protect DNOs against potential high £/kW costs.

Adjustment for connection boundary

- 5.10. All DNOs who responded on this issue support the option preferred by Ofgem, ie an ex-post adjustment in the price control formula.

Treatment of tax

- 5.11. DNOs supported aligning the treatment of tax in DG incentive with that in the overall price control. Some saw the need to maintain equivalent incentive strength post-tax for all DNOs by using company specific allowances. However,

others saw the benefit of a simpler approach of using an average marginal tax rate.

Ancillary services

- 5.12. Some DNOs were disappointed that no special allowance for ancillary services will be given. They argued that some ancillary services may not be self-financing through reducing capex or opex, and that DNOs should not be penalised for the costs incurred.

Innovation Funding Incentive (IFI)

- 5.13. **Ofgem confirmed its Initial Proposals for the IFI in the June consultation, in particular the profiled pass-through rate reducing from 90 per cent in year 1 to 70 per cent in year 5. It was also proposed that IFI projects could be initiated from 1 October this year.**
- 5.14. A number of respondents have continued to argue for a higher pass through rate but no challenge was made to the cap of 0.5 per cent of turnover, the R&D Intensity. Additional points of concern were the cap on internal expenditure and the need to justify projects before commencement.
- 5.15. *Ofgem continues to hold the view that the average pass through rate of 80 per cent is appropriate. The financial exposure that this presents to a DNO will encourage careful selection and management of projects and co-operation with other DNOs to share risk. The pass through profile proposed will encourage early participation by DNOs.*
- 5.16. *Ofgem accepts the view that the project justification process should be proportionate to the size of the project involved but remains of the view that ex-ante justification is necessary to protect consumers' interests. These processes will need to be addressed in the proposed Good Practice Guide which will be approved by Ofgem. Concern about the cap on internal expenditure was only expressed by two DNOs and so no change is proposed here.*
- 5.17. The early start proposal has been well received. Ofgem has received positive responses from all DNOs.

Registered Power Zones

- 5.18. **In the June consultation Ofgem made two further proposals relating to RPZs. In response to a widely held view that the originally proposed RPZ premium was not in balance with the risks involved, Ofgem decided to increase it to £4.5/kW. Also, in order to concentrate effort on high quality projects, Ofgem proposed to limit registrations to two per licensee per year for the first two years.**
- 5.19. Comments received in response to the June consultation focused primarily on points of detail rather than principle. Most importantly, calls for a further increase in the RPZ premium were limited though one DNO said that it was still not high enough to encourage them to seek RPZ opportunities. Other responses were more positive.
- 5.20. *Ofgem is of the view that the level of the premium is now consistent with the risks involved.*
- 5.21. A number of parties expressed concern about the proposed limit of two registrations per licensee per year.
- 5.22. *This is encouraging in that it indicates a desire to engage in RPZ projects. However, Ofgem considers that it is appropriate to have this control in place for the first two years as it will allow Ofgem, the DNOs and new generators to gain valuable experience in this initial period which will inform the proposed review in 2007.*
- 5.23. One DNO questioned whether a storage plant could attract the RPZ premium.
- 5.24. *The use of storage in a distribution system raises a number of regulatory issues and there may be a case for a focused consultation on them. However, there would appear to be a good case for allowing the RPZ premium to be available for the connection of innovative storage technology.*
- 5.25. Arguments have been put forward for the RPZ premium to be available for projects involving existing generation only.

- 5.26. *This has been given consideration but as existing generators are not caught by the new structure of generator connection and use of system charges, which includes the DG hybrid incentive, it has been decided that this proposal will not be pursued.*
- 5.27. The point has also been made that the structure of the RPZ incentive acts against innovation for micro generators.
- 5.28. *This point is accepted but Ofgem considers that DNOs could allocate IFI funding to this class of generator connection. Modification of the RPZ mechanism is therefore not considered necessary.*
- 5.29. One DNO argued for a funding route to be identified to cover the failure of an RPZ project.
- 5.30. *Ofgem is strongly of the view that the risk of project failure is balanced by the RPZ premium and sees no case for a 'back up' funding mechanism.*
- 5.31. Several other detailed points were raised which will be addressed in the RIGs and the proposed Good Practice Guide.

6. Cost assessment

Operating costs

Methodology

- 6.1. Two DNOs considered the methodology to be flawed, with one of those DNOs listing a number of perceived deficiencies. It went on to state that a poorly specified benchmarking model was not a proper basis for setting revenue allowances. All DNOs preferred the use of an average regression line rather than an upper quartile. Some other respondents agreed with the use of the upper quartile.
- 6.2. A number of DNOs expressed their concern that an opex/capex trade-off was not adequately accounted for in the analysis. Some DNOs wanted the effects of mergers and total cost to be directly incorporated into the regression rather than through the use of Ofgem's alternative regressions. One DNO did not want mergers, quality and total cost to be incorporated into the regression. Those respondents who wanted total cost analysis to be used generally preferred using a capital stock approach. Some respondents also wanted quality to be more fully incorporated into the regression.

Normalisation

- 6.3. Some DNOs questioned the consistency of the direct and indirect cost information that was submitted by the DNOs. Another DNO said that their non-operational capex used in the normalisation needed to be adjusted.
- 6.4. One DNO commented that many definitional problems remain, which undermine the robustness of this work. Another suggested that the reasons that it was not at the efficiency frontier could plausibly be attributed to unresolved accounting differences. Some DNOs were concerned about the consistency of the treatment of faults/replacement capex.
- 6.5. Three DNOs were critical of the comparability of the data inputs and the methodology used for total costs analysis, with one of these proposing the

introduction of a “reporter” as is used in the water industry. Another DNO noted that the data supported its claim to be efficient on a total cost basis.

- 6.6. One DNO said that they thought the regression is reasonably robust.

Regional factors

- 6.7. Three DNOs claimed that their distribution areas should merit an adjustment for regional factors. Both of the DNOs that Ofgem has adjusted in the normalisation for regional factors wanted a higher adjustment. Some DNOs had submitted reports from consultants as support for their views and one DNO was disappointed by Ofgem’s response to their consultants report.

Treatment of faults in cost analysis

- 6.8. One DNO said that total faults should not be included with opex in the cost analysis and preferred a bottom up approach to fault costs. One DNO said that they agreed that faults should be included with opex in the regression analysis. Some DNOs said that they wanted a different treatment of faults e.g. an allowance in addition to the base regression or an adjustment to the analysis.

Forecast BPQ figures v normalised 02/03 figures

- 6.9. Four DNOs commented that the normalised costs were given undue weighting compared to company FBPQ submissions in determining future opex allowances. Some of these DNOs considered that the significant differences between FBPQ forecasts and normalisation data indicated that the normalised costs data was insufficiently robust to be totally relied upon.

Efficiency v error

- 6.10. Three DNOs considered that it was possible that the deviation of a company’s position from the regression line was due to statistical error rather than inefficiency, so the results of the benchmarking exercise should be viewed with caution. One of these DNOs suggested that some error is due to data definition problems, so in ignoring this, Ofgem is discriminating against some DNOs. Some DNOs suggested using a confidence interval.

Composite Scale Variable (CSV)

- 6.11. Three DNOs considered that the CSV was incorrect, with two commenting that it had little relevance to real cost drivers, so the reliability of the output was questionable. One DNO agreed with the CSV proposed by Ofgem. Another DNO wanted a bigger weighting on network length whereas other DNOs wanted a smaller weighting on network length. One DNO said that they were concerned about using network length because it was unaudited. One DNO thought that a higher weighting should be applied to HV customers.
- 6.12. Another respondent was disappointed that quality of service performance was not directly included in the CSV and urged Ofgem to reconsider its inclusion at the earliest opportunity. Some DNOs thought that the effect of faults was not adequately covered by the CSV.

Glide path and catch up

- 6.13. Three DNOs commented that cost savings and restructurings take time to achieve and require upfront expenditure. They considered that these factors need to be incorporated in allowances if no glide path is to be allowed.
- 6.14. Two DNOs and some other respondents welcomed Ofgem's proposal not to allow a glide path and to assume 100% catch up, with one of these stating that the use of an upper quartile and the increased confidence in the base regression rendered the use of a glide path unnecessary.

Frontier shift

- 6.15. Five DNOs questioned the validity of Ofgem's interpretation that the CEPA work supported a 2 per cent ongoing efficiency improvement. Two of these considered that this would only be appropriate if the average benchmark was being used, while another stated that it could equally be interpreted that TFP growth would match GDP with no additional gains. One of these asked for an explanation for the differences between Ofgem's and Ofwat's assumptions on efficiency improvement. Some other DNOs also mentioned Frontier Economics work in this area. One DNO suggested that a 2 per cent frontier shift could be

used but only if an average regression line was also used instead of an upper quartile.

- 6.16. One other respondent claimed that CEPA's report suggests an ongoing efficiency of at least 4 per cent per annum which is higher than Ofgem had assumed.

Ernst & Young analysis

- 6.17. Two DNOs noted that Ernst & Young (E&Y) claimed that there was limited scope for opex reductions, whilst two other DNOs claimed that Ofgem's proposed allowances were incompatible with the conclusions of the E&Y work. One other DNO expressed concern that with the number of separate strands of work on cost assessment, there was scope for "double dipping" of efficiencies and for the setting of unattainable targets. One DNO said that they disagreed with the results of the E&Y work.

Storm insurance and atypicals allowance

- 6.18. Three DNOs claimed that the allowances for storms and atypicals were inadequate and urged Ofgem to reconsider the data.
- 6.19. One DNO stated that the removal of atypically high costs without the equivalent removal of atypically low costs biased the analysis towards costs that are unsustainably low.
- 6.20. Three DNOs considered that the analysis excluded a range of other costs that should have been classified as atypical. One of these DNOs also claimed that some costs were removed for the purposes of normalisation and that they would need to be given an allowance for them.

Tree cutting modelling

- 6.21. Three DNOs claimed that Ofgem's model of tree cutting costs is deficient and has resulted in a significant understatement of their true costs for this activity.

Capital expenditure

Historical capex and RAV roll-forward

- 6.22. Two DNOs agreed that the RAV should be rolled forward on the basis of the policies used to set DPCR3 capex allowances, but one of these emphasised that only the policies adopted by frontier companies in 97/98 were relevant.
- 6.23. One DNO proposed that there should be no adjustment to the RAV for the disposal of assets that have been fully depreciated and are no longer required by the company.
- 6.24. Another DNO proposed that the costs of post-fault asset replacement and efficient expenditure on non-op capex in excess of its allowance should be included in the RAV. It was also proposed that a constant percentage uplift, based on the figures for DPCR3 frontier companies, should be used as the yardstick for testing additions to the RAV.
- 6.25. A further DNO noted the clearer definition of fault costs used by Ofgem in the Initial Proposals and stated that this should be applied consistently by Ofgem, without exception. One respondent said that they looked forward to a robust review of DNOs asset disposals particularly those that have been transferred into related companies or relate to the transfer scheme.
- 6.26. One DNO disagreed with the exclusion from the RAV of all inter group margins on services provided from within the group that could be obtained from third party service providers.
- 6.27. Another DNO commented that its overhead allocation policies are broadly in line with those of the DPCR3 frontier companies in 97/98 and therefore there should be no adjustment to the RAV.

Capex allowances

- 6.28. Two DNOs commented that the process that has been followed to assess future investment requirements placed insufficient emphasis on their asset strategy and business plans and on the detailed information provided during the Ofgem visits.

- 6.29. Two DNOs expressed disappointment that although there was general agreement between their base forecasts and PB Power's assessment, the company own case was not adopted. Another DNO was critical of the PB Power assumption that the current level of network risk is acceptable and claimed that schemes had been incorrectly disallowed by PB Power on this basis.
- 6.30. Four DNOs were critical of PB power's process, claiming that where a company's submission was lower than PB Power's assessment, the lower figure was used. This has lead to claims of "cherry picking" from those DNOs of costs and that the process is biased downwards, which will lead to increased risk of network failure. One of these DNOs claimed that the expenditure cuts proposed by Ofgem would lead to an unacceptable deterioration in its network.

ESQCR/Fluid filled cables

- 6.31. Two DNOs noted that their submissions may have been affected by the inclusion of data related to ESQCR and fluid filled cables and proposed that their data should be adjusted accordingly. Most respondents agreed with Ofgem's approach to ESQCR and fluid filled cables.

Sliding scale mechanism

- 6.32. Three DNOs gave their explicit support for the principle sliding scale mechanism, but one of these commented that incentives should be stronger and another considered that the benchmark should be common for all companies so that companies who are able to manage risk will be rewarded appropriately.
- 6.33. Two DNOs expressed opposition to the sliding scale mechanism; one of these on the basis that the PB Power estimates were not a robust means of establishing the benchmark, while the other expressed a wide range of objections to the mechanism.
- 6.34. One non-DNO considered that the sliding scale mechanism was an interesting development in the incentive regime, but queried the use of additional revenue and allowances in excess of the PB Power estimate. It considered a simpler

version of the mechanism would be more understandable and would be less likely to produce unintended consequences.

Other

- 6.35. One DNO commented that they thought the capex incentive scheme should only apply to savings compared to the allowance and not expenditure in excess of the allowance.

7. Financial issues

Cost of capital

General

- 7.1. Several respondents argued that there is no justification for a base cost of capital below that proposed by Ofwat³ for the water industry. It was argued that Ofgem's proposed cost of capital takes insufficient account of the increased risks and reduced opportunities for out-performance.
- 7.2. It was also argued that only a cost of capital at the top end of the range would meet City expectations. However, one non-DNO respondent argued that given current market data, there is little evidence to support a significantly higher cost of capital, it therefore supported the mid-point of the range (i.e. 6.6 per cent pre-tax real) but not higher. Another respondent said that it accepted, indeed it is impossible to refute, that the use of the historic equity beta of the sector empirically results in a post-tax real WACC of around 4.6 per cent.

Comparison with water sector

- 7.3. It was argued that it is essential that Ofgem's final proposals are consistent with Ofwat's views. One financial respondent remarked that discrepancies between regulators do little to reduce regulatory risk.
- 7.4. Another financial respondent argued that UK water companies have traded at a substantial discount to RCV for the majority of the current review period having been allowed a return of 4.75 per cent post-tax real. It also argued that the rates of return for comparable European companies are higher both in absolute and relative terms; capital might be expected to flow to those points if higher returns are provided.
- 7.5. It was also argued that on the basis of volume risk, operational gearing, financial risk and the treatment of uncertainty, DNOs seem to be at least equally risky to

³ Periodic Review 2004, Future water and sewerage charges 2005-10 - Draft determinations

the water companies and that this would indicate that the top end of Ofgem's proposed cost of capital range would be appropriate.

- 7.6. However, one respondent pointed out that the Ofwat cost of capital figure might have been driven by large capital programmes and persistent negative cash flow and that such constraints do not present themselves in DPCR4. *Ofgem sees merit in this view.*

Cost of capital and wider incentive framework

- 7.7. It was argued that if incentives are not strengthened then a higher cost of capital is required. But it was also argued that the cost of capital is insufficient as it doesn't reflect the increased risks for DNOs, with one of the reasons being given the strengthening of quality of service incentives.
- 7.8. One DNO argued that investors are becoming increasingly wary of investing in UK utilities and that there is an increased perception of risk in the industry resulting from (among other factors) opportunities and incentives for outperformance being reduced and that significant increases in investment are changing the industry risk profile and cashflow characteristics. It also argued that assumed opex efficiencies which are aggressive increase operational risks.
- 7.9. *Ofgem accepts that what matters to investors is the achievable return on equity and hence the cost of capital should be seen as part of the wider price control risk-return package. In the main document (September document) Ofgem has indicated some changes to aspects of the overall package, which might be expected to reduce risks relative to the Initial Proposals.*

Cost of capital and cost assessment

- 7.10. One DNO argued that the transfer of costs (elements of faults, non-operational capex and overheads) from the 'expensed' to the 'depreciated' category would increase the risks that the costs might not be recovered and that this should be recognised through an increase in the cost of capital.

Cost of equity

- 7.11. It was pointed out that under the assumption that there would be ongoing growth in dividends and given current and recent DNO dividend yields, DGM suggests a cost of equity in the range of 6.96 per cent to 7.75 per cent.
- 7.12. It was also argued that Ofgem's estimate of the cost of equity was based on internally inconsistent data, because the beta of 1 is based on equity betas observed directly from stock market returns for companies with an average gearing level of 38 per cent and hence Ofgem should have delevered and then relevered these directly observed equity betas for its 60 per cent gearing assumption.
- 7.13. *As Ofgem has pointed out in its March 2004 Cost of capital appendix, observed monthly electricity betas have fallen from approximately 1 in the 1993 to 1999 period to approximately 0.3 at present. As pointed out by Smithers & Co in their report on beta estimation for Ofgem (and as summarised in the March Cost of capital Appendix) this fall in observed equity betas could be due to 'markets learning' about these companies and the regulatory regime, therefore, in the years directly following privatisation these companies might have been regarded as relatively risky, whereas since then the regulatory regime as well as the companies have become more familiar to investors and are now regarded to be relatively low risk compared with the 'average' listed firm. However, given that there is some evidence of parameter instability, Ofgem decided to propose a range for equity beta from 0.6 to 1.0.*
- 7.14. Also, according to one respondent there are a number of significant inconsistencies between the basis of Ofwat's and Ofgem's WACC decision in relation to ERP and risk free rate, with Ofwat proposing an ERP in the range of 4 per cent to 5 per cent, whereas Ofgem proposed a range of 2.5 per cent to 4.5 per cent and for the risk free rate Ofwat proposes 2.5 per cent to 3 per cent, whereas Ofgem proposes 2.25 per cent to 3 per cent.

7.15. It was also pointed out that Ofcom⁴ has used an ERP of 5 per cent for Partial Private Circuits Price Control.

7.16. *However, this respondent did not mention that Ofcom also used a nominal risk free rate of 4.75 per cent whilst assuming 2.8 per cent for inflation. A comparison of the Ofgem mid-point value, Ofwat's draft proposal and Ofcom's Partial Private Circuits Price Control values for the WACC is given in the following table.*

Table 7.1 Comparison of recent regulatory cost of capital calculations

	Ofgem mid-point	Ofwat 2004	Ofcom 2004⁵
Inputs			
- cost of debt (pre tax)	4.1	4.3	2.9
- cost of equity (post tax)	7.25	7.7	8.2
- gearing	60%	55%	35%
Results			
- vanilla WACC	5.36%	5.8%	6.3%
- pre-tax WACC	6.6%	7.3%	9.4%
- "post-tax" WACC	4.6%	5.1%	5.8%
Return on equity for "average" company (beta = 1)	7.25	7.7	6.8

Ofcom uses a lower cost of debt and has a lower aggregate return on equity than either Ofgem or Ofwat, but uses a higher equity beta of 1.3, based on observed market data.

7.17. Another DNO argued that with the significant capital requirements and potential negative cash flows for some DNOs it is essential that the cost of capital is sufficient to attract equity investment and that in its view this would require a return on equity in excess of 10 per cent if DNOs are to be able to compete in the international capital markets.

⁴ Partial Private Circuits Charge Control, Ofcom, 24 June 2004

⁵ Nominal values converted to real values using the formula: Real = (1 + Nominal)/(1 + 2.8%) - 1

Cost of debt

- 7.18. Some DNOs argued that the projected cost of debt need to allow for the prospect of increasing interest rates as well as embedded debt and debt issuance fees.
- 7.19. *Ofgem has adopted a relatively wide range for the risk-free rate for the reasons set out in the March 2004 Cost of capital appendix. Similarly, Ofgem adopted a relatively generous range for the debt premium given current market data. These ranges however reflect the uncertainty surrounding the expected risk free rate and expected debt premium and Ofgem is of the view that these ranges remain appropriate.*

Gearing

- 7.20. It was argued that Ofgem's treatment of the remuneration of tax at different levels of gearing appeared to effectively force companies with a gearing less than 60 per cent to gear up to 60 per cent or otherwise they would face being underfunded for tax during the next control period. It was pointed out that this would prevent companies from exercising choice about how to finance their businesses and that this policy seems logically inconsistent with the proposals on the use of minimum financial ratios as a tool to assess financeability. It was stated that the regulator might assume that the company can avoid a financing problem by issuing equity while at the same time potentially not remunerating the company for the increased tax payments associated with the new level of gearing.

Tax

- 7.21. Several respondents stated that they did not agree with the assumptions used by Ofgem to calculate tax. Several DNOs argued that Ofgem has significantly underestimated their tax bills. One DNO argued that incentive payments should be on a gross basis and the ensuing tax liability should be taken into account in the price control calculation of tax. Some DNOs have questioned Ofgem's use of nominal interest in the tax calculation and one suggested doing the calculation in real terms. One DNO suggested that Ofgem should adopt a form of pass through for tax.

Regulatory asset value and depreciation

- 7.22. Three DNOs agreed to the principles applied in respect of depreciation of the RAV, with one of these noting that the Scottish companies should be given the same treatment at the next price control. However, one other respondent considered that the approach adopted meant that consumers end up paying for assets more rapidly than their assumed asset life and charges are higher than they otherwise would be.

Pension Costs

Allocation between price-controlled and non-price-controlled activities

- 7.23. Two respondents argued against the default 80 per cent figure used by Ofgem to allocate pension liabilities between the regulated distribution activity and other activities. Both argued that the proportion allocated to distribution should be higher.
- 7.24. One non-DNO respondent urged Ofgem to ensure DNOs were not seeking compensation for deficits incurred in unregulated activities and to ensure that all the costs of the regulated (distribution) business were taken into account.

Early retirement deficiency costs (ERDCs)

- 7.25. The DNOs main concern with Ofgem's pension calculations was the treatment of ERDCs. They all argued against reducing the allowed deficit by the extent to which ERDCs had been funded out of scheme surpluses in the past.
- 7.26. While some were against any deduction for ERDCs (arguing that they were legitimate costs efficiently incurred), others saw merit in allowing a proportion based on the NPV of the share of efficiency gains accruing to the company versus those accruing to the customer. Of this latter group, many argued that the proportion attributable to customers was higher than the 70 per cent indicated in the June document. One DNO argued that rather than calculate a standardised

share, Ofgem should look at the actual timing of redundancies that were partly funded using scheme surpluses and calculate an actual share for each DNO.

- 7.27. One non-DNO also argued against any disallowance of ERDCs, although if some compromise was necessary they saw some merit in apportioning in line with the share of benefits. They too said the proportion attributed to the companies should be less than 30 per cent.
- 7.28. However another non-DNO respondent supported Ofgem's position on ERDCs in the June paper. They argued that it was reasonable to expect companies to absorb any increase, or retain the benefit of any decrease, in the cost of providing enhanced pension benefits granted under severance arrangements that were not fully matched by increased contributions.

Other

- 7.29. One DNO said they would oppose any fixed allowance for future service costs since the level of future service costs is influenced by factors outside the DNO's control e.g. average age of workforce, scheme investment strategy, etc. They said that future service costs, as certified by an actuary, should be allowed in full.
- 7.30. One non-DNO thought it would be reasonable to ignore the impact of investment returns had ERDCs been paid into the scheme, because investment decisions are based on the capital available to the scheme and if different amounts were available the investment decision would have been different.

Financial indicators

Financing issues

- 7.31. Four DNOs suggested that since one company appears to have a major financing issue and several others come close to breaching the test ratios, the industry-wide cost of capital would need to be adjusted upwards from the current modelling assumption in order to ensure the companies could finance all of their functions. One of these noted that there were still a number of materially significant areas of activity excluded from the financial model.

- 7.32. One other respondent considered that weak ratios were an indication of poor management and any compensatory adjustments to ensure financeability should come from shareholders rather than a customer bail-out.
- 7.33. Another respondent requested additional clarity on Ofgem's criteria for a "major financing issue". This respondent also questioned the willingness of shareholders to inject equity into a business that was seen to have financing issues.

Choice of financial indicators and threshold levels

- 7.34. Two DNOs commented that they agreed with the choice of the three measures proposed by Ofgem, but proposed alterations to the test ratio levels. One DNO said Ofgem should look at ratios after 2010 and include other factors like DG and metering in the modelling.