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Dear Ayesha

I am sorry that I have missed your deadline for commenting on the recent consultation on Initial Proposals for an electricity transmission network reliability incentive scheme. I hope that you will, nevertheless, be able to take account of our views. We recognise that these proposals have been prepared as an interim step to provide additional assurance to customers before the next transmission price control review. We wish to set out the steps that we would expect to be taken before a more permanent incentive scheme could be put in place. Our views build upon our experience with the IIP and the discussion over its enhancement as part of the current distribution price control review.

I have therefore set out below a number of questions that come to mind from reading the document. We would expect these to be answered in developing a more permanent approach.

*Why is the scheme asymmetrical?* Is this just a reaction to the public and political concern over recent high profile transmission events?

*Why has £39,130 per MWh been used as the incentive rate?* Although this is the key factor in the incentive scheme, it is not even stated in the document, let alone discussed. This figure seems to have been accidentally determined as a function of the two separately estimated variables

- a) the lower edge of the dead band; and
- b) the maximum reward judged to be appropriate.

Surely, there must be some information available to Ofgem from the electricity market that would give a rough estimate of whether this figure is even of an appropriate magnitude. Its estimation leads to two obvious further questions, namely:

*Why is 1% an appropriate figure for the maximum reward?* The document implies that a penalty regime of plus 1% to minus 1.5% of revenue will not have a material impact on the cost of capital, but there is no explanation of how Ofgem have come to this conclusion.

*Why is the bottom of the dead band set at 10% lower than current performance? Indeed why is a dead band created at all? Dead bands generally only serve to create disjoints and distortions in incentive arrangements that reduce their effectiveness and can introduce perverse incentives across boundaries.*

*Why is 600MWh set as the upper limit for this incentive mechanism? It seems from the document that this figure is also determined as an unconsidered consequence of the incentive rate happened upon as described above and the maximum penalty Ofgem think may be acceptable to NGC.*

The defence that these arrangements are consistent with the arrangements for the DNOs Information and Incentives Project is a poor one. The maximum revenue exposed to the IIP scheme was not based upon customers' willingness to pay, but rather a rough judgement on the part of Ofgem as to what DNO's might agree to when faced with the alternative of rejecting the entire 2000 price control review settlement. The recent Customer Survey conducted by Accent on behalf of Ofgem has actually indicated that customers are willing to pay a great deal more for improvements in quality of supply. Ofgem has chosen not to use these results in revising the incentive rates for the updated Information and Incentives Scheme.

Your paper makes it clear that you have only tried to develop a stop-gap arrangement. It is disappointing that the paper fails to articulate the processes that you would like to follow in developing a future scheme, and to suggest how the criteria selected for short-term use compare with those that might be employed in future. I hope that our comments will be useful in your future considerations. If you would like to discuss any of the points we make, please give me a call.

Yours sincerely

Mike Boxall  
Head of Electricity Regulation