

13 February 2009

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Dear Nicola

### **Electricity distribution price control review 5 policy paper**

We set out below our views on the overall approach and process being adopted to the distribution price control review 5 (DPCR5) and highlight some of the key issues we think it is important to address from a customer perspective. Our concise responses to the questions posed by Ofgem are attached.

We note that Ofgem considers it is likely that customers will see an increase in charges attributable to distribution from 2010. If this change is necessary, it is essential that the regulatory settlement is absolutely clear about what customers are to get in return both through carefully selected output measures and the allocation of risk between the companies and consumers and the rationale.

### **Interaction with RPI-X@20 review**

We are concerned that the process and timetable for DPCR5 overlaps with that of the RPI-X@20 review. The reasoning for the longer-term review is that the RPI-X style of regulation may not be the best way to deliver new and emerging challenges including the need to move to a low carbon economy and to support investment and ensure security of supply. We agree that the current framework has become too complex, making it difficult for stakeholders to understand and engage in the process.

The leisurely timetable set by Ofgem for the RPI-X@20 review creates additional risks and uncertainty. Recommendations are due in the fourth quarter of 2010, at the same time DPCR5 comes into effect. Ofgem says that 'in the event that any changes are recommended under the RPI-X@20 review which could have implications for investment incentives implemented via DPCR5, we would take steps to put in place appropriate arrangements to ensure effective transition from the existing arrangements'. At this stage, stakeholders have no idea what this may entail. This could create significant regulatory risk for the companies and therefore unknown impacts on consumers.

We are also concerned at the lack of substantive progress that has been made in the longer-term review since it was announced nearly a year ago. It has yet to proceed beyond the stage of defining the overall objectives and the nature of the building blocks despite the stated importance of the review.

As a consequence of the limited progress, DPCR5 is being executed along similar lines to the process undertaken for the current price control. Given the urgency of the policy challenges, we doubt it is right to shoehorn DPCR5 into the current framework and then selectively superimpose the results of the RPI-X@20 review afterwards. While hindsight suggests the long-term review should have been initiated immediately after closure of DPCR4, it was not. The RPI-X@20 review should not be scoped to last two years. There should be active read-across from the RPI-X@20 review to DPCR5 and it is helpful that members of the review team attended the recent DPCR5 workshops and that the Director leading on DPCR5 also sits on the review project board. Ofgem needs to ensure that early learnings from the review are incorporated into DPCR5 to minimise uncertainty. We think it will be better to adopt a pragmatic approach rather than strive for the ‘perfect model’ that comes too late to make a real difference and too great a cost.

### **Stakeholder engagement**

Turning to the issues under review, Consumer Focus welcomes the regulator’s intention to see DPCR5 as the first step in developing wider and more timely stakeholder engagement. In the initial consultation, Ofgem said it expects the experience gained as part of this review to inform the RPI-X@20 review when it assesses alternatives to the current approach, and it has separately identified a possible greater emphasis on ‘negotiated settlements’.

We support the principle of constructive engagement during price control reviews. We see this development as extremely important in helping to ensure that the distributors invest in ways that better take into account consumers’ needs and preferences and ensure better and more responsive planning and budgeting.

Better engagement during the review process is especially important at the current time given the increasingly complex drivers of future investment and the uncertain economic background. The range of possible future network scenarios developed under the long term electricity network scenario (LENS) project, the excessively large increases in network investment forecast by the distributors and the associated operating costs indicated by the DNOs for DPCR5 mean that stakeholders, including representatives of consumers who ultimately pay the distribution charges, should be closely consulted. The dialogue if it is to deliver real benefits needs to evolve beyond the traditional approach of open-ended and periodic snap shot consultation such as the current one, but where the real negotiation is conducted privately between the regulator and the companies. In particular, the choices and decisions the

regulator makes and the positions taken by the companies need to be supported by cogent and well-supported arguments and suitable information and analysis.

Ofgem has held stakeholder workshops and stressed that it expects each DNO to undertake consultation with its regional stakeholders in order to inform their business plans and revenue demands. It has also formed and is drawing on a group of consumer experts, intended to act as a critical friend. We welcome these steps, but it would be useful to start to develop principles and good practice guidelines in order to embed these practices more generally into the price control review process going forward. We thought the stakeholder workshops were useful in helping understand other stakeholder views and provided an opportunity to have some initial discussions around key consumer issues such as how to address the problems faced by worst served customers. It would have been helpful if the notes of the workshops had been published further in advance of the deadline for responding to the consultation so that stakeholders would have an opportunity to reflect on issues raised in sessions they had not attended and reflect on in their submissions.

Looking forward, codification of the process would enable consistency across DNOs during DCPR5 and provide a more transparent and consistent basis for other regulatory reviews.

### **Reducing unnecessary complexity**

Ofgem has rightly highlighted the complexity of incentive-based price control as it has evolved in Britain. A discernible feature of the practice of price control as it has developed has been fragmentation in the number and complexity of incentive arrangements. In turn, this has made it much harder for non-industry parties to engage in the process. This trend has been compounded by the fact that each price control review has developed in an ad hoc way, with emphasises on different issues. Where common themes and issues have been addressed, they have often been tackled in different ways.

Consumer Focus considers that the increased emphasis on outputs should enable the process to achieve better focus on the key deliverables, while at the same time establishing a much more explicit performance metric between the companies. If anything this adjunct is likely to increase complexity, not reduce it. An important area where there is significant complexity is in the various incentives and regulatory tools to manage risks set out by Ofgem in the document. It is in this area that attention should be focussed (see below).

### **Nature of the settlement**

The many uncertainties in the current and future environment put the issue of risk and where it falls firmly at the centre of the current price control review. The issue of risk sharing between the companies and consumers and funding innovation in monopolies is key. We are

considering whether there is additional research that Consumer Focus could undertake in this area to feed into the DPCR5 process. Ofgem's proposal to develop the DPCR5 settlement to require DNOs to deliver a pre-defined set of outputs in a sustainable manner is a very necessary move. We also agree with the assessment that under DPCR4 the focus has been on inputs rather than delivered outputs. It is in any case a necessary feature of the process of improved stakeholder engagement that there should be a range of focussed and explicit outputs against which DNOs can be measured.

Given that the DNOs are forecasting very large increases in capital spend over the five years, it is important to identify outputs to ensure both 'value for money' and to ensure that the spending is carried out so as to develop and shape the network in the directions dictated by consumer preferences and to meet environmental objectives.

The networks should not, as Ofgem notes, continue to regard the price control settlement as a fixed budget or a 'revenue requirement'. The introduction of the sliding scale sharing factors under DPCR4 where distributors see incentives to forecast accurately represented a significant improvement on previous practice. However, if forecasts prove wrong or are over-stated, much greater emphasis needs to be placed on claw-back of (with hindsight) unnecessary revenue allowances. We believe there is a lower probability of over-spending against allowances as the companies are naturally biased against this. However, there needs to be much better reporting of asset condition so that quality of supply is not subordinated to profit. This is one area where output measures should be targeted.

This issue is highlighted by the fact that some networks are already finding it difficult to spend their capital allowances for DPCR4. It is likely that given some of the reasons provided, which relate to the difficulties of ramping up capex to the levels they have indicated because of internal resourcing and external supply issues, they will not be able to spend what they have forecast is needed for DPCR5. In principle, networks should get rewarded for their expenditure based on delivering outputs which are driven by customers and penalised for failure to deliver.

It could be appropriate to have two types of settlement, as Ofgem suggests, depending on how well-defined the outputs are. However, we consider there is merit in encouraging consistency across the DNOs. From a consumer perspective, different approaches are likely to create confusion and limit the capacity for comparisons between DNOs.

In dealing with uncertainty within the price control, a key issue is where the risks fall and how large these risks are. We agree with the criteria proposed for deciding which approach to take to different categories of cost (p16). However, the overall sharing of risk between customers and distributors is key to the settlement and needs to be considered in the round, as a package. We welcome, for example, (4.17) Ofgem's view that any current backlog created as a

result of the DNOs constraining the level of investment in DPCR4 should be recovered at a cost to shareholders, not customers.

## Incentives

We note that Ofgem is leaning towards retaining most of the mechanisms adopted within DPCR4, as it believes the behaviour that they are designed to encourage is still relevant. We find it surprising then that Ofgem without apparently having carried out substantive analysis should default at the outset of DPCR5 to this position, especially when some in the industry seem to be questioning how they work.

To illustrate:

- The existing distribution losses scheme may have outlived its usefulness. Distribution losses amplify costs to customers and have a real environmental impact through higher than necessary generation. This basic physical reality of the power system should be taken directly into account by DNOs in their investment decisions, and where networks exacerbate the problem they should see penalties. The current practice of beating targets is very game-able, and the rewards enjoyed by distributors have been disproportionate despite the fact losses have increased materially over DPCR4 to date. The proposals dive into the detail and seem to miss some of these higher considerations, though Ofgem does acknowledge the possible need to factor in costs of some low loss equipment in the DNOs capex forecasts. It is also not clear why the DNOs' hybrid solution has been rejected. Many aspects of the policy proposals are resource intensive, but the potential benefits arising from a fresh approach in this area could be considerable.
- It is not clear from the policy paper what the economic logic in the current distributed generation (DG) mechanism is, with DNOs offered generous incentives to respond to demand-led initiatives. We would prefer a clearer focus on incentives than information, though we agree the current allowance rate should be reviewed (i.e. reduced). Ofgem notes that the DNOs greatly over-stated the amount of DG during DPCR4 based on developments to date. We do not believe this is simply a feature of planning delays.
- The form of RPI-X control adopted over the past 20 years has led to a collapse in R&D by the companies, so a special inducement was belatedly offered during DPCR4 through the Innovation Funding Initiative (IFI) and the Regional Power Zone (RPZ). Ofgem proposes to drop one mechanism (RPZ) but not the other (IFI), but the rationale is unclear. Ofgem says the current arrangements do not go far enough, but the three options identified to deliver a more general incentive are described only at a high level. An alternative would be to make an allowance based on a proportion of expenditure, have retrospective review perhaps after two years and then disseminate best practice.

As a guiding principle we agree there needs to be a better linkage to ensure rewards are only earned for genuine improvements in performance. In this context, it would have been helpful

to see what incentive payments have been made under all these schemes and what Ofgem considers as the drivers behind the associated performance.

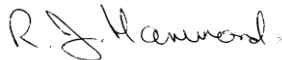
### **Customers' priorities**

We note that Ofgem has undertaken detailed consumer research as part of the DPCR5 process. We would however highlight that willingness to pay on its own will not deliver the full answer. It is also worth noting that the changes in the economy at large and increasing debt levels will likely affect many consumers' willingness and ability to pay.

We welcome moves to develop a broader measure of customer satisfaction and the emphasis on the worst served customers. Measures should also be developed to protect vulnerable consumers. We believe that weightings should be applied to the various elements. We also consider that there needs to be a much more holistic assessment of the demand-side and how distributors can play a role in signalling the need for more efficient usage. It is important to ensure that we look at more innovative non-network solutions. The smearing of investment costs across all consumers where there are viable cost effective alternatives would be an inefficient outcome.

Please let me know if you would like clarification on any of the points in this letter. We would be delighted to meet to discuss our response and the views expressed in it.

Yours sincerely



**Robert Hammond**  
**Head of Regulated Industries**

## Distribution price control review 5 policy paper consultation

### Chapter 1: Introduction and overview

**Question 1:** Do you agree with our assessment of how the DPCR4 settlement has performed in practice?

**Broadly, yes. In particular we agree with Ofgem's comments on the sub-optimal operation of the specific incentive mechanisms and the absence of meaningful output measures. We note that only one of the 14 DNOs is forecast to earn below Ofgem's assumed equity return over the five year control. The other DNOs are all set to outperform – one by 3.5%.**

**Question 2:** Do you agree with the main lessons we have drawn from this assessment?

**Yes though we are disappointed that because of RPI-X @20 timetable some of the key lessons are not to be taken into account for DPCR5.**

**Question 3:** Have we identified appropriate measures to address our concerns and deliver a settlement that provides better rewards/penalties for highly performing/poorly performing companies?

**The thrust of the approach and its greater emphasis on output measures is correct.**

**Question 4:** Do you think our proposal to base DNOs' incentives for under/outperformance around their effective return on equity is appropriate?

**It is a sensible enhancement, though a basket of financial ratios should be applied in parallel.**

**Question 5:** If you do, what range of return on equity do you think would represent a fair balance between customers' and shareholders' interests to reward increased efficiency, better service and innovation, whilst maintaining strong incentives for shareholders of any poorly performing DNOs to improve performance?

**Values should be set after, not before analysis. Experience from other sectors and markets need to be factored in.**

### Chapter 2: Environment

**Question 1:** Do you agree with our view of future uncertainties and the need for DNOs to change their way of working and thinking to encompass innovation and flexibility?

**Definitely, yes.**

**Question 2:** What are your views on our proposals for DNOs to provide more information to help low carbon initiatives and have we adequately identified and defined the information requirements?

**The answer is yes with regard to the requirement. The information identified is a good starting point but needs to be kept under review as the process develops.**

**Question 3:** Do you agree with our proposal that all distributed generation should pay use of system charges, and if not, can you provide evidence to substantiate your specific concerns?

**No comment.**

**Question 4:** Do you agree that the distributed generation (DG) incentive should be retained? Should embedded transmission be deemed relevant DG?

**The current approach takes no account of the benefits DG can bring through delaying investment elsewhere in a DNOs business.**

**Question 5:** What are your views on our proposals on innovation and flexibility? How would you rate their feasibility and which option is most likely to drive the more innovative and flexible behaviour that we are seeking?

**They require further development. An ex ante approach will be gamed given the uncertain nature of the activities; a within-period mechanism is to be preferred, but could be bureaucratic; while an ex post approach is too discretionary.**

**Question 6:** What are your views on our proposal to set an incentive on transmission grid exit charges?

**No comment other than to note that the current approach places all the risk on consumers.**

**Question 7:** What are your views on our losses proposals, and do you have any additional comments on the option to install smart meters on low voltage substations?

**This is a complex matter requiring further analysis. The existing mechanism is blunt. It is not clear why distributors should see large incentives to do something they should arguably already be doing.**

**Question 8:** What are your views on the various aspects of the business carbon footprint proposals?

**It seems sensible but requires further development.**

**Question 9:** What are your views on our proposals for refining the undergrounding scheme? In particular, should we apply caps per km of cable by voltage level or should we remove all voltage caps and just have a single overall cap?

**No comment.**

**Question 10:** Do you agree with our proposed approach for the treatment of fluid filled cables?

**No comment.**

### **Chapter 3: Customers**

**Question 1:** Do you think that the range of existing and proposed arrangements will deliver the levels of service customers expect?

**Ofgem has conducted extensive and useful research to understand what customers want from their DNOs. This needs to be examined carefully and tied to the companies' detailed estimates of expenditure.**

**Question 2:** What percentage of revenue/return on equity should be exposed to customer service and how should it be split between the various areas?

**We would like to see some clearer proposals from Ofgem on this to respond to.**

**Question 3:** Do you agree with our intention to develop a broad measure of customer satisfaction and the proposed advocacy approach?

**Yes.**

**Question 4:** Do you agree with our proposed approach to connections, which of the options do you support and why?

**No comment.**

**Question 5:** Do you agree with the proposed amendments to the IIS (in full) and what are your views on how incentive rates should be structured?

**The direction of the proposed changes are correct, subject to further development (in full).**

**Question 6:** Do you agree with our proposed long-term objective of DNOs being able to automatically know which of their customers are off supply and the exact times, and if so what is the appropriate timescale to achieve this?

**It is surprising that distributors do not have this capability and they should be required to have it as a matter of urgency.**

**Question 7:** Do you agree with the proposed focus on worst served customers and which of the options do you prefer?

**Yes.**

**Question 8:** We have raised some detailed questions throughout this chapter and the appendix. We welcome views on these issues.

**No comment. We would observe that many of these matters are too detailed for an initial consultation.**

#### **Chapter 4: Networks**

**Question 1:** Have we identified the right behaviours for DNOs? Are there others which should be included?

**No comment.**

**Question 2:** What action should we take where a DNO has deferred investment and created a backlog in DPCR4?

**It should see a claw-back in the allowed revenue.**

**Question 3:** What approach should we manage to deal with volume uncertainty?

**No comment save that volume drivers and output measures should be linked.**

**Question 4:** What approach should we take to price uncertainty?

**Regulated network prices should in the main be predictable and maximum prices capped (subject to the operation of K factors).**

**Question 5:** Should we be looking to equalise incentives for opex and capex? If so, what approach should we adopt?

**There looks to be merit in this approach but it needs further exploration to ensure this does not lead to different perverse or unintended consequences.**

**Question 6:** Do you consider that we should make refinements to the IQI? If so, what changes should we make?

**Yes. These should be scoped further.**

**Question 7:** What action should we take where DNOs provide insufficient output information as part of their February FB PQ?

**They should be penalised. Ofgem should use its information powers to correct this.**

**Ultimately it should transplant its own view of reasonable costs.**

**Question 8:** Do you agree with our proposed approach to assessing network operating costs and indirect costs?

**Yes.**

**Question 9:** Do you agree with our proposed approach for assessing network investment?

**Yes.**

#### **Chapter 5: Financial issues**

**Question 1:** Have your views on the appropriate methodology for setting the cost of capital or on indexing the cost of debt changed as a result of the current turmoil in the capital markets?  
**No.**

**Question 2:** What is the appropriate timing of actuarial valuations for setting ex ante pension allowances (see also appendix 10)?  
**No comment.**

#### **Chapter 6: Process**

**Question 1:** We invite views on which format stakeholders would find most useful for the Ofgem workshops to be held in January 2009.  
**The workshops have already taken.**

**Question 2:** We invite views on our proposed process.  
**See covering letter.**