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# Networks breakout session

28 January 2009

## Introducing additional output measures

- Output measures are a key feature of the price control arrangements for a number of reasons:
  - Should be the basis of DNOs' management of the network
  - Integral to the assessment of DNOs' historical and forecast costs
  - Ensuring that DNOs deliver – value for money
  
- We are looking for DNOs to commit to a DNO specific package of measures as part of the price control settlement including:

Overall customer performance	<ul style="list-style-type: none"> <li>– Number and duration of interruptions</li> <li>– Customer satisfaction with the DNO</li> </ul>
Load related spend	<ul style="list-style-type: none"> <li>– Connection or customer driver</li> <li>– For highly loaded substations, number of customers at risk, potential time at risk, extent of load growth</li> <li>– Asset utilisation</li> </ul>
Non load related spend	<ul style="list-style-type: none"> <li>– Fault rates</li> <li>– Indices for the condition of the network</li> <li>– Modelled percentage remaining useful asset life</li> </ul>

## Varying the settlement based on outputs

- We are broadly proposing two classes of settlement for DPCR5 dependent on the robustness of information from the DNOs
- These are characterised below.
- We expect all DNOs to aim for type one

Type one – Well defined outputs	Type two – Limited outputs
– Common base cost of capital	
<ul style="list-style-type: none"> <li>– Challenge to DNO forecasts</li> <li>– Tightly defined outputs which are measurable and verifiable</li> </ul>	<ul style="list-style-type: none"> <li>– Extra challenge to forecasts</li> <li>– More limited output information</li> <li>– Greater use of CI, CML and fault rate</li> <li>– Use of some input measures</li> </ul>
<ul style="list-style-type: none"> <li>– High powered incentive scheme</li> <li>– Easier to reach high returns based on verifiable performance against costs and outputs</li> </ul>	<ul style="list-style-type: none"> <li>– Lower powered incentive scheme</li> <li>– More difficult to obtain higher returns</li> </ul>
<ul style="list-style-type: none"> <li>– Limited scrutiny of underspend as long as output measures are met</li> </ul>	<ul style="list-style-type: none"> <li>– More intrusive scrutiny of any underspend against capex allowances</li> <li>– Ex-post review of capex (three pots treatment)</li> </ul>
– Common CI, CML incentive rates and common standards of performance	

## Questions on output measures

- What are your views on output measures?
- Paragraph 1.4 of the briefing note sets out our requirements for output measures? Are these appropriate? Are there additional ones we should be adding?
- What should the overall scope of output measures be?
- What's reasonable to deliver in this price control? What's reasonable to deliver in the future?
- What steps should be taken in this price control review for DNOs who do not provide sufficient output information?
- What action should be taken at the next review for DNOs who fail to deliver their outputs?

## Managing uncertainty - volumes

Existing revenue drivers	Current view
Units distributed	<ul style="list-style-type: none"> <li>– Possibly incompatible with energy efficiency drives</li> <li>– Poor cost driver</li> </ul>
Customer numbers	<ul style="list-style-type: none"> <li>– Poor cost driver for overall capex</li> </ul>

Potential capex drivers	How used	Issues
Gross new customers or LV connections	Capex driver customer driven load related expenditure	<ul style="list-style-type: none"> <li>– Capturing gross rather than net</li> <li>– Driver on gross capex or net?</li> </ul>
MW growth	General reinforcement	<ul style="list-style-type: none"> <li>– Only on substations with relatively high loading</li> </ul>
Triggers	Major reinforcement projects	<ul style="list-style-type: none"> <li>– Highly uncertain projects with large materiality</li> </ul>

Existing revenue drivers are ineffective. Exploring new capex drivers/triggers

## Managing cost uncertainty - prices

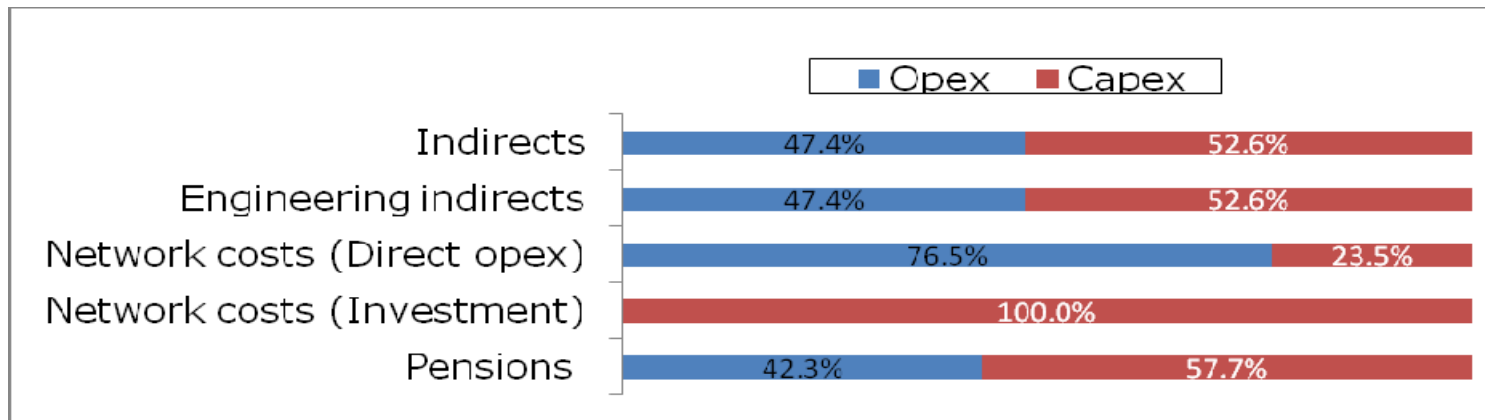
- Greater volatility in commodity prices (in particular copper) than at other recent price control reviews
- There is a risk we set prices at their peak – this suggests that indexation may be appropriate
- Question about how much risk we place on the companies versus customers
- We don't want to remove the incentive on DNOs to manage costs where they can
- Appropriate approach could entail allowing DNOs / customers exposure to a band of price risk after which indexation kicks in
- However, there is no "ready made" index and constructing an appropriate one may prove difficult

## Questions on uncertainty

- What approach should we be taking to managing the impact volume/demand uncertainty on network investment?
- How should we manage uncertainty in unit costs? For example, rapid changes in equipment prices or labour costs?
- How should risks be shared between shareholders and customers?

## Equalising the incentive rates for capex and opex

- Improving cost incentives & remove boundary issues
- Addressing possible distortions between opex and capex incentives
  - May encourage companies to develop more tools including capacity loading and utilisation measures to monitor risk and defer work
  - Encourages use of demand-side management and of DG to defer capex
  - Trade-off between inspections and maintenance more limited. Most I&M costs have legal and safety drivers
- Some practical issues to work through such as:
  - appropriate dividing line/ what proportion of costs to capitalise into the RAV



## Questions on equalising incentives

- Should we take further steps to equalise cost incentives?
- How could this be most effectively be done?
- What are the potential advantages and pitfalls?

## Information Quality Incentive

- IQI places greater weight on DNO forecasts and encourages them to put in more realistic forecasts
- The DPCR4 IQI matrix takes the form of two incentives.
  - DNOs are allowed to earn an additional income on their RAV based on how close their forecast is to our baseline
  - It sets the incentive rate for future efficiency savings based again on how close the DNO's forecast is to our baseline.
- Under the incentive a DNO with an inflated capex forecast is able to keep a lower percentage of any capex underspend than a DNO with a more accurate forecast.
- We consider that this approach has been beneficial in encouraging distributors to submit more realistic forecasts
- However a range of concerns have been raised with the approach

## Questions on the IQI

- What further steps could we take to ensure companies deliver more robust forecasts?



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