Electricity Distribution Price Control Review Final Proposals

Document type: Appendices

Ref: 144a/09

Date of publication: 7 December 2009

Target audience:
Consumers and their representatives, distribution network operators (DNOs), independent distribution network operators (IDNOs), owners and operators of distributed energy schemes, transmission owners, generators, electricity suppliers and any other interested parties.

Overview:
Ofgem regulates the 14 monopoly regional DNOs to protect the interests of present and future consumers. We set a price control every five years that sets the maximum revenues that each DNO can collect from customers at a level that allows an efficient business to finance its activities. We also place incentives on DNOs to innovate and find more efficient ways to provide an appropriate level of network capacity, security, reliability and quality of service.

The current price control expires on 31 March 2010 and Ofgem has now completed the Distribution Price Control Review (DPCR5) to set the controls for 2010-15. This document is an appendix to our Final Proposals, summarising the responses that were received to both the Initial Proposals document and September update letter.

Contact name and details: Rachel Fletcher - Partner, Distribution

Tel: 020 7901 7209

Email: DPCR5.reply@ofgem.gov.uk

Team: Distribution, Local Grids and RPI-X@20

Context

This document is an appendix to the main distribution price control review five (DPCR5) Final Proposals. The main document sets out our final decisions on the revenues each of the 14 DNOs should be allowed to collect from their business and domestic customers between 2010 and 2015. We explain the outputs and levels of service customers can expect from the DNOs over this period in return for what they pay. We also explain the incentives to improve performance and the obligations on DNOs that we will introduce as part of the price control settlement. The DNOs have until 6 January to state whether they will accept these proposals. If they do not then we intend to refer the matter to the Competition Commission.

In December 2008 we published our Policy Paper. This focussed on three key themes: environment, customers and network and set out our views on the overall approach to setting the control, our proposed methodologies, the structure of incentives and the new regulatory arrangements we considered appropriate.

In February 2009 all DNOs submitted updated forecasts for the final two years of distribution price control review four (DPCR4) and the five years of DPCR5. These were reduced from their initial level in August 2008, but still showed significant forecast increase in network investment and operating costs between DPCR4 and DPCR5. We identified significant issues with the forecasts and sought further information from DNOs to justify their forecasts.

In May 2009, we published our Methodology and Initial Results document, which set out details of our costs assessment methodology and initial results for a number of core cost areas. We explained that we would continue to develop our work in this area as we worked towards Initial Proposals.

In August 2009, we published Initial Proposals. We sought views on the outputs we expect and the behaviours we want to encourage from the DNOs and the mechanisms we propose to achieve them. We sought views on our initial view of the proposed revenues for the 2010 to 2015 period, and on the scope for shareholders to out or underperform our allowed rate of return within the price control period.

In September 2009, we published an update letter focussing on those areas of cost which we were not able to include in Initial Proposals because we required further information from the DNOs and other parties to form a view on the appropriate baseline revenue allowance.

In October 2009 we provided a written update to each of the DNOs on our view of allowed costs and revenues. We published these letters for stakeholders to consider.

While developing Final Proposals, we have taken into account views raised by stakeholders throughout the price control review. We have also continued to work closely with the RPI-X@20 review team, who are undertaking a root and branch review of the way we regulate electricity and gas, transmission and distribution networks in the future.

Associated Documents

- Electricity distribution price control review. Initial Proposals (92/09)
- Electricity distribution price control review. Initial Proposals - Incentives and Obligations (93/09)
- Electricity distribution price control review. Initial Proposals - Allowed revenue - Cost Assessment (94/09)
- Electricity distribution price control review. Initial Proposals - Allowed revenues and Financial Issues (95/09)
- Cover note Electricity Distribution Price Control Review Initial Proposals – Financial Model 2010-15
- Electricity Distribution Price Control Review - September Update to Initial Proposals

Table of Contents

Appendix 4 – Summary of responses to the Initial Proposals consultation document

Chapter summary

This chapter summarises the responses received for the electricity distribution price control review: Initial Proposals.

Core document – Behaviours, Incentives, Funds and Obligations

Have we introduced a set of measures that can be understood by customers and other stakeholders?

1.1. The majority of respondents broadly agreed that the measures could be understood by customers and other stakeholders. However, a number of respondents pointed out that the measures are more complicated than previous price controls and some of the transparency has been lost.

Are we aiming to encourage the behaviour you consider appropriate for DNOs in the 2010 to 2015 period?

1.2. The majority of respondents to this question agree that Ofgem has identified the right behaviours for the DNOs under the themes Environment, Networks and Customers.

1.3. One respondent suggests that reducing the absolute incentive rate for DG is a backward step at a time when significant DG is required to meet the Government's carbon agenda.

1.4. One DNO disagreed that an incentive on transmission exit charges was appropriate.

Are the proposed mechanisms likely to be successful?

1.5. The DNOs expressed various views where they had concerns with the proposed mechanisms.

1.6. One respondent suggests further work is necessary on the incentive mechanisms and believe the mechanisms may be unsuccessful due to poor incentive properties. They suggest the strength of the incentive for the IQI mechanism has reduced as it does not suitably differentiate between DNOs who have submitted robust and credible forecasts and those who have not. In order to correct this they suggest applying the current matrix on an asymmetric basis and also linking forecasting accuracy to output measures.

1.7. Another respondent was supportive of the current size and balance of incentives with the exception of network losses where the incentive captures settlement errors as well as carbon reduction. They do not feel the willingness of customers to pay for such improvements is as high as network performance.

1.8. On the subject of network losses, another respondent feels that the incentivisation is misdirected as it does not recognise the constraints arising from data issues.

1.9. One respondent wants to ensure that the mechanisms associated with the incentives, funds and obligations are not over-complicated with burdensome reporting.

Core document - Proposed allowed revenues

Have we taken an appropriate approach to setting allowed revenues?

1.10. The majority of responses to Ofgem's proposed approach for setting the allowed revenues came from DNOs.

1.11. The responses from the DNO's noted that up until Initial Proposals they had been happy with the methodologies used in forming the initial view. However, the DNOs that responded indicated that they had concerns with the latest iteration of the benchmarking methods.

What assumptions do you think we should use for real price effects on DNOs over the 2010 to 2015 period?

1.12. While a number of DNOs supported Ofgem's view of continued increases in efficiency, the majority raised concerns over Ofgem's RPE assumptions. These concerns were focused on the labour RPE assumptions for 2008-09 and 2009-10. Most DNOs also argued strongly for the inclusion of a wage growth premium for specialist labour due to skill shortages in the industry. One DNO argued for a distinction between RPEs for internal and contractor labour. A supplier agreed with our approach to capex RPEs but believed that our assumptions for opex RPEs were too generous to the DNOs.

What are your views on PwC's range for WACC?

1.13. The responses from the DNOs were generally consistent, saying that the range was too low and too broad. They believed that the low end of the range was not viable while the upper end of the range does not reflect current financing costs. Most of the DNOs argue that there has been a fundamental re-pricing of risk following the credit crunch.

1.14. On the whole, the DNOs did not agree with the time periods used by PwC in their analysis saying that the work assumes a return to pre-credit crunch conditions and that there is an insufficient amount of emphasis on forward looking projections, particularly for the cost of equity.

1.15. One DNO said that the analysis did not consider embedded debt that was efficiently raised when rates were higher.

1.16. A number of respondents argued that there is greater uncertainty in DPCR5 than DPCR4 which warrants a higher cost of capital.

1.17. A number of respondents acting on behalf of consumers generally believed that the PwC range was too high for what is a very safe investment.

Do you think we need a mechanism to address cost of debt uncertainty?

1.18. The bulk of the DNO responses were opposed to a cost of debt trigger, saying they would prefer to see an appropriate cost of capital set. Only one response, from a supply company, said that a cost of debt trigger was suitable saying it is an appropriate way of handling the uncertainty on the cost of debt.

1.19. A number of respondents said that companies were better suited to managing interest rate risk than customers. Similarly another respondent said that setting an appropriate ex ante allowance provides a stronger incentive for companies to manage their financing costs.

1.20. One respondent said that a cost of debt trigger makes it less clear for investors what returns they can expect.

1.21. One respondent said that they did not feel there was sufficient time left in the process to implement a cost of debt trigger.

What are your views on the debt trigger mechanism?

1.22. The majority of the responses highlighted the cons of a debt trigger with most believing they are unnecessary. The principal reason was that it would be too complicated.

1.23. One respondent said that there are a number of pros; including reducing the risk of financial distress, the need for headroom and an increase in transparency. However, the cons would include a practical difficulty in the ongoing monitoring and the fact it may be a departure from RPI-X regulation. There is also the possibility that it may be triggered unnecessarily as a result of the focus on debt - for example the cost of equity may remain steady or fall and so keep overall cost of capital at an acceptable level and yet the trigger may be triggered as a result of a rise in the cost of debt.

1.24. A number of respondents said that a cost of debt trigger would reduce the incentive of companies to effectively manage their interest rate risk.

1.25. One respondent said that a trigger mechanism would be appropriate in volatile markets but seek additional information on its proposed application.

1.26. One respondent said that a cost of debt trigger would lead to an unwelcome volatility in system charges.

Core document – Risks and Rewards

Do you agree with our approach to calibrating the price control settlement?

1.27. The respondents were not opposed to the policy per se, but were concerned about the lack of information provided around the mechanism and thought the focus should be on getting the WACC right.

Do you think DNOs should be awarded a low baseline WACC and be given opportunities to earn more through outperformance, or a higher WACC with more limited opportunities to earn through outperformance?

1.28. The respondents were concerned that there would be a different WACC for different DNOs. The DNOs all responded that the WACC should be set the same for all DNOs and set at a level where out-performance was rewarded.

What comments do you have on our early views on how different incentives should be calibrated and the impact on customers' bills?

1.29. Almost all respondents indicated that there was insufficient information for them to determine how the different incentives could be calibrated and how the customers' final bills would be impacted.

Do you agree with our proposed mechanisms for handling uncertainty?

1.30. The majority of respondents agreed with Ofgem's proposals for handling uncertainty. A number of respondents requested further information on our proposals in some areas. One DNO argued for the inclusion of a substantial effects clause.

Incentives and Obligations – Low carbon networks fund

Do you agree with our proposals for a new mechanism to encourage DNOs to develop their role in the low carbon economy?

1.31. All DNOs, and most other respondents, agreed with our proposals. Some suggested further refinements, or identified specific issues, which are detailed further in the responses to the questions below. Several respondents requested more detail on various aspects of the proposal such as eligibility, consumer benefit, panel composition, guidelines and rewards.

1.32. It was also noted that there are projects already under development that could be progressed into a field trial.

1.33. Several non DNOs expressed disappointment that the fund is only available to DNOs directly.

In particular, do you agree with:

- **the proposed size of the funding?**
- **the proposals for discretionary rewards?**
- **the two tier structure?**
- **the proposals to recover tier 2 costs over a five year period?**
- **the measures to mitigate DNO risk?**

1.34. Most respondents agreed with the proposed size of funding, with one suggesting it is sufficient for five large smart grid projects nationwide. One DNO cautioned that there is a risk it could be ineffective due to cuts in cost allowances within the overall DPCR5 proposal.

1.35. The proposal for discretionary rewards received a mixed response. For example, one respondent considered that they should provide adequate incentive for DNOs to develop schemes, whilst another stated that they would not provide sufficient incentive to drive behavioural change. One respondent considered the reward size excessive compared to the overall size of fund. Another respondent said that the discretionary reward should be subject to a clearly defined and transparent decision process.

1.36. All respondents that commented agreed with the two tier structure, although one argued that tier 2 does not promote shared learning given the applications for funding are competitive.

1.37. One respondent agreed with the proposal to recover tier 2 projects over five years, whilst one thought Ofgem should consider a shorter depreciation period.

1.38. Two respondents agreed with the risk mitigation measures and considered them fair.

Do you think we have adequately balanced the DNOs and customer risk?

1.39. There was general agreement that the balance between DNO and customer risk was right, although several respondents felt that they did not have enough detail to properly evaluate the balance. One stated that Ofgem needs to ensure activities are not sponsored which could be funded by competitive businesses, as this could lead to crowding out of market driven innovation.

1.40. Intellectual property was a common concern, in particular whether it can be shared in practice with the benefits being distributed back to customers.

1.41. One DNO considered that the mechanism does not adequately reward the DNOs' risk in undertaking trials.

Do you agree that DNOs should be allowed to use any benefits accrued from the project to cover their contribution (minimum 10 per cent) to the project funding, or should the direct benefits be subtracted from the project cost before the DNO contribution is calculated, so that the DNO always contributes at least 10 per cent of the project cost?

1.42. This question raised mixed responses. Three respondents argued that any benefits achieved should be allowed to cover any contribution that DNOs have made to a project. Another stated that benefits should be shared with equipment supply partners. One believed that if the project is effective in its purpose, the DNO should pay a higher proportion of costs than 10 per cent to ensure consumer benefits.

1.43. One respondent stated that benefits should not be clawed back before they are realised as this would distort decision making, and prevent valuable projects being proposed. Another respondent thought that a DNO needs to retain any benefits in order to incentivise innovation.

1.44. One respondent stated that we should not be too restrictive on allowed costs.

Do you agree that the funding should be provided on a use it or lose it basis, and should the tier 2 funding be ramped up over the period?

1.45. The majority of respondents agreed with the proposals, but one thought use it or lose it should be restricted to the latter three years and ramping be inverted to 125% in year 1 and 75% in year 5 to provide stronger incentives for DNOs and to accommodate the projects manufacturers have already identified. Two respondents stated we should provide more funding towards the end of a price control period.

1.46. One respondent supported ramping up, but suggested flexibility on the use it or lose it approach should be considered.

Do you consider that this mechanism will achieve our stated objectives?

1.47. Some respondents felt this scheme was as good as any to bring forward flagship projects and was a step in the direction. However, others questioned whether the Low carbon networks fund (LCN fund) would be able to achieve its objectives. One did not consider that DNOs will take up the opportunity that the fund offers. Another argued that the discretionary reward mechanism is too subjective to determine whether it will be a success, with a mechanistic approach with more obvious markers for success needed. A third stated it was unclear as so many issues were still unresolved.

1.48. One respondent stated that Ofgem needs to take a proactive role in working with DNOs and third parties to identify appropriate projects. A DNO proposed that a research and development group be set up through the ENA to develop proposals.

Incentives and Obligations – Provision of Information to Distributed Generation

Have we correctly captured the customer's information needs?

1.49. In general respondents considered that we have correctly captured customer's information needs. Several DNOs however flagged that different customer groups would have very different informational requirements and that they did not necessarily have visibility of this at this point in time. One DNO thought that customers do not need the information that Ofgem is proposing.

1.50. Several non DNOs highlighted the need for more detailed information at lower voltage levels, although a DNO argued that providing information for LV networks will be expensive.

Do you agree with the scope of proposed licence obligations?

1.51. There were mixed responses to this question, especially around whether the proposed licence obligations would provide developers with the information they require, and also concern around the cost of providing the information.

Do you agree with our proposal to request DNOs to commit to a strategy for information provision?

1.52. All responses agreed with the proposal for an information strategy, although there were differing views as to what should be included within it.

Incentives and Obligations – Distributed generation (DG) incentive framework

Do you agree with our proposal to retain the DG incentive framework largely unchanged from DPCR4, and do you have any comments on the detail of our proposals?

1.53. Respondents agreed with the retention of the DPCR4 mechanism, although one disagreed that it stays unchanged. Some respondents questioned whether the incentive actually encourages the connection of DG, and one advocated a scheme which encouraged or allowed a DNO to invest ahead of need.

1.54. One respondent welcomed the retained cap and floor, whilst another proposed that the cap and collar period should be extended to cover cash flows in both DPCR4 and 5 in order to encourage investment.

1.55. There was agreement with the proposal to move to single demand and generation revenue pot.

Incentives and Obligations – Use of system charging to pre-2005 connected Distributed Generation

Do you agree with our proposal to terminate the blanket exemption from use of system charges for pre-2005 connected DG, with effect from 1 April 2010?

1.56. This question provoked mixed responses. Five DNOs agreed with the removal of the blanket exemption, although several raised concerns around how the charges would be implemented and when.

1.57. Three respondents, including one DNO, disagreed with the proposals – arguing that it is not discriminatory given that different arrangements were in place at the time the pre-2005 DG connected.

1.58. Several DNOs raised concerns about compensation, in terms of the potential value and the resources required to arrange it.

Incentives and Obligations – Transmission exit charges incentive

Do you agree with the proposed hybrid approach for the regulatory treatment of transmission exit charges?

1.59. Two non DNOs welcomed the proposals and the hybrid approach, although one suspected it would be difficult to set the allowed amount.

1.60. All DNOs expressed their disagreement with the proposal, since they consider they have limited control over these costs. There was some feeling that these costs are already regulated (under the transmission price control) and that there is no evidence to suggest distribution networks have been developed uneconomically as a result of passing through these costs.

1.61. There was concern over the accuracy of the transmission operator's forecasts, with one DNO stating that the proposal does not incentivise the delivery of a technical solution, but just rewards or penalises the long term forecasting accuracy of DNOs. One DNO suggested that if the proposal is introduced changes will need to be made to allow greater scrutiny of National Grid outturn costs and provide the DNOs with the ability to challenge them.

Do you agree that in setting the scope of the incentive we targeted the appropriate cost items?

1.62. Two DNOs agreed that if an incentive scheme was established, it should focus on GSP expansion requirements caused by the DNO. One noted that forecast exit charges are subject to change, and therefore the incentive scheme should be designed to be neutral to input prices.

Do you agree with the level of exposure under the proposed sharing factor?

1.63. There were mixed DNO responses to this question – two agreed, one disagreed and one suggested that it should be considered at a later date in light of further information.

Incentives and Obligations – Losses incentive

Do you agree with our proposal to provide explicit funding for justified low loss investments to provide direct recognition of the investment?

1.64. The majority of respondents agreed with the proposal, although one doubted the accuracy of the forecasts of loss reductions resulting from the investments.

Do you agree with our proposals (common reporting, reporting lag) to address the issues associated with using settlement data to measure losses?

1.65. There was broad agreement to the common reporting – although respondents were sceptical about whether the reporting lag would address all settlement data issues. Several DNOs restated that they believed an input based losses incentive is more appropriate, although one supports the hybrid approach.

1.66. One respondent stated that they do not agree with changes to losses incentive because the current incentive has not been in place long enough to change.

1.67. Comments were made about the detail of the methodology such as the choice of settlement data run type.

What are your views on our proposals for a common reporting method and where we have identified options, which do you prefer?

1.68. Issues were raised about the detail of the common reporting methodology, with one respondent stating that it was still under development and therefore could be subject to unintended consequences. They proposed that the DPCR4 method be retained to run in parallel with the DPCR5 proposed methodology.

Do you agree with our revised losses incentive value and our proposal to retain the rolling retention mechanism?

1.69. Responses on the incentive value varied, with suggested amounts ranging from £6/MWh to greater than £60/MWh. One respondent suggested that the shadow price of carbon should be excluded from the incentive value, whilst another suggested that there be two different incentive values, one for technical losses and one for non technical.

1.70. The majority of DNOs stated that they would prefer an annual cap and collar on the losses incentive, with a narrower range than proposed in Initial Proposals, although one stated that if the cap and collar was annual it could be wider than the overall cap/floor proposed. One DNO offered that the cap and collar could be asymmetric, tighter on the upside than the downside.

1.71. Two respondents did not agree with the retention of the rolling mechanism as it would exacerbate the impact of inaccurate or volatile data.

1.72. Concern was also expressed over the impact of smart metering on the mechanism.

Do you agree with our proposals for a common treatment for substation energy usage, where the substation usage is registered with a supplier so that they pay for the electricity consumed?

1.73. The majority of respondents welcomed the proposal, although one thought it is unnecessary as the proposal provides no benefits and increases costs. They considered that the cost of metering is likely to out-weigh benefits. However this was addressed by a response proposing that if energy usage is de minimis and installing meters is impractical then it is more pragmatic to register these sites as unmetered supplies. There was also some concern around forecasting the usage over DPCR5 and the opportunity for windfall gains or losses in respect of adjustments to targets.

Do you agree with our proposals to recognise and reward improvements to the losses measurement?

1.74. Two respondents noted that improved measurement does not actually lead to reduction in losses, although one supported the proposal. One respondent suggested that smart metering may better deliver improvements. They also proposed that Ofgem should target other measures to improve data quality such as working with suppliers to actively target theft, although a second respondent was concerned that suppliers may not play their part in revenue protection activities as there is no financial incentive for them to do so.

Incentives and Obligations – Treatment of DPCR4 losses rolling retention mechanism

Do you agree with our proposal to leave the DPCR4 losses incentive open for the first three years of DPCR5 until the settlement corrections are complete? What are your views on our proposal that the absolute losses performance will be exposed to the DPCR4 rolling retention mechanism?

1.75. Most respondents agreed broadly with our proposals, one stating that they are appropriate given the different methods used by DNOs to calculate losses in DPCR4. However some believed there is a lack of clarity about how Ofgem intends to implement the proposals, and disagreed with the proposal to revise the final year data based on later settlement corrections.

1.76. It was flagged that the DPCR4 losses performance as implemented through the roller mechanism must not be included in the cap and collar arrangements for DPCR5, otherwise inappropriate returns may be retained.

Do you consider that the proposals for closing out the DPCR4 rolling retention mechanism have merit, and if so, how should we manage the uncertainty?

1.77. The majority of respondents did not think it would be possible to agree a buy-out option with the DNOs.

Incentives and Obligations – Business carbon footprint (BCF) reporting

Do you agree with our proposal for BCF reporting requirements?

1.78. All respondents agreed with our proposals, although some cautioned that the reporting needs to be proportionate to the materiality of the emissions.

Do you agree with the proposed guidance for the BCF reporting methodology?

1.79. There was agreement with the proposed guidance, although a DNO highlighted that it needs further modifications. One DNO noted that including scope 3 contractor emissions will introduce a burden on contractors.

Do you agree with our proposal to rely on a reputational incentive only (through publication of a league table)

1.80. Respondents agreed with our approach – that it is inappropriate to introduce financial incentives to such a new measure when there is no historic consistent data. It was considered that the reputational incentive will encourage transparency.

Incentives and Obligations – Undergrounding in Areas of Outstanding Natural Beauty (AONBs) and National Parks mechanism

Do you agree with our proposed amendments to how the undergrounding allowance is formulated?

Voltage Caps

1.81. All respondents who voiced an opinion on the removal of voltage caps welcomed them as a way of giving the scheme more flexibility and ensuring that larger and more desirable schemes are not rejected outright due to the caps.

Scheme remaining voluntary

1.82. The one DNO that responded on this issue welcomed the continuation of the scheme as a voluntary undertaking between the DNO and relevant stakeholders. Five environmental and conservational groups accepted the rationale behind Ofgem's decision but explained their desire for Ofgem to encourage all DNOs to engage with stakeholders. Three conservation groups stated their disappointment at the decision to continue the scheme on a voluntary basis.

Boundary issues

1.83. Nine environmental and conservationist respondents explained their disappointment at the scheme not extending to lines just outside the boundaries of specified regions. They each felt that the requirement on planning authorities to incorporate visual amenity requirements in their planning countered Ofgem's argument that extended the terms of the scheme would lead to a certain level of confusion. One of these respondent explained that they could cite examples of schemes that had been abandoned midway through as they were discovered to include particular lines outside the boundaries. The one DNO who responded on this issue expressed some understanding of why the decision was taken by Ofgem.

Project officer

1.84. Of the five environmental and conservationist respondents that referred to the position of project officer as part of the scheme, all felt that it was vital to the success of the scheme. Three were however accepting of the fact that it was probably not Ofgem's role to designate how particular elements of the allowance should be apportioned. The other two felt that funding for the role should come directly out of the DNO allowances as the expertise and direction the position gave to schemes and stakeholder discussions were invaluable.

Interaction with asset replacement work

1.85. Two respondents welcomed the proposed use of the undergrounding allowance as a means of funding the gap on normal asset replacement for an underground solution where the work is being carried out for visual amenity reasons. The one DNO that responded on this issue felt that it would be helpful if the allowance could be used to enhance normal asset replacement work.

Treatment of new lines

1.86. All of the six environmental groups that responded on the issue of how new lines in the designated areas should be treated were disappointed with Ofgem's proposal and urges them to reconsider. Each of these respondents accepted that there were mechanisms in place to address the issues around new lines in planning laws but emphasised that these would still result in extra costs which would have to fall on either the landowner or the local planning authority.

Do you agree with our proposed approach to undergrounding projects not completed by the end of DPCR4?

1.87. All of the thirteen respondents that addressed Ofgem's proposed approach to projects carrying over from DPCR4 welcomed the proposals as a step in the right direction. However, four environmental groups and a DNO felt that it would be beneficial to further develop the level of overlap by changing the definition of when a project is complete.

Incentives and Obligations – Connections incentives and obligations

Do you agree with the scope, timeframes and the level of penalties proposed for the guaranteed standards regime?

1.88. Across the DNO groups there was a general concern that the guaranteed standards regime proposed was too detailed and lacked flexibility. They felt that a number of the standards could be streamlined, both in terms of the overall number and slightly differing timeframes across voltage levels. In particular they felt that the budget estimate quotation standard would often be unhelpful for the end customers with disproportionate penalties. They also felt that the short period of time left to implement major system alterations would be extremely challenging and costly. In contrast, the vast majority of other respondents felt that the scope of the proposed standards, as outlined in initial proposals, were broadly representative of the key elements and timeframes involved in the connections process, although a significant number were at pains to point out that the penalties were not reflective of the commercial loss to customers but were acceptable as a means of incentivising DNO performance.

Should we develop a mechanism to ramp up the level of the proposed penalty payments?

1.89. All DNO respondents were opposed to the idea of a ramp up mechanism. Conversely, all the customer respondents insisted that the development of the mechanism would be important as a means for dealing with persistently bad performing DNOs. The independent connection provider (ICP) respondents were somewhat split on the issue with one suggesting that, providing that the penalties remain uncapped, a ramp up mechanism may just complicate the process and monitoring of performance and another suggesting that it would be an important element of the package.

Should we cap the penalties that apply to each of the proposed standards?

1.90. Six of the seven DNO groups stated that there should be a cap on guaranteed standards in line with the equivalent payments in gas and other guaranteed standards within the Electricity Distribution Licence. All other respondents felt that the uncapped penalties as proposed were the only way of ensuring that DNOs were incentivised to treat all jobs on an equal basis and not prioritise particular jobs to minimise their economic exposure.

Should we apply in aggregate a 90 per cent performance target to apply to the standards and measure this on a quarterly basis?

1.91. In general, DNOs were not opposed to an overall performance target. However, several felt that this should be done on an annual basis in line with other licence conditions. Their concerns over the standards being measured on a quarterly basis relate to the possibility of a quarter of poor performance impacting on their ability to earn margin and the threat of what can be described as a “triple jeopardy, where a quarter’s failure against the overall performance target might lead to three forms of penalty in terms of guaranteed standard payments, loss of margin and potential fines". The customer representatives that responded were accepting of an overall standard as long as this did not imply that there was an acceptable number of jobs in which the standards would not have to be met. Each of the IDNO and ICP respondents felt that 90% as a performance was insufficient and should at the very least, rise over time. The Unmetered customer representatives all felt that the target should be set at 100%.

Do you agree with our market segmentation strategy for metered and unmetered connections? Are there any segments other than those identified that should be exempt from earning a margin?

Metered

1.92. In general there was agreement across the board in terms of the segments which had been outlined by Ofgem. However, there were some concerns raised over the segmented strategy with one ICP representative suggesting that it would not be appropriate for DNOs to earn an unregulated margin until all relevant segments had been deemed competitive. His rationale for this was that a segmented unregulated margin would allow DNOs to cherry pick the market. A consultant shared this concern and raised another regarding a 4% margin on connections involving EHV, which would immediately provide DNOs with a huge source of added revenue without having to demonstrate any improvement. Conversely, a DNO representative suggested that their limited outlay in this area made it difficult to determine whether EHV is of a sufficient size to justify its own segment. Another ICP welcomed the segmented approach but emphasised the need to ensure that DNOs were not including any standalone schemes below 60kVA in the LV segments where a margin would be applicable.

Unmetered

1.93. A public service provider welcomed the expansion and disaggregation of the unmetered market. An association representing electrical contractors in unmetered connections suggested that the limited expansion of unmetered connections to include PFI schemes meant that other important long-term contracts were not being considered.

Are there any segments other than those identified that should be exempt from earning a margin?

Metered

1.94. Apart from the market segments marked in Initial Proposals as being exempt from the margin, there was limited opposition to any other metered market segments being exempt from earning a margin in absolute terms. However, a customer representative suggested that in their experience, ICPs would have limited interest in works that don't involve HV and above work and so suggested these works should be exempt from the margin since competition is unlikely to develop in this sector. An ICP representative also suggested that since there is a limited number of ICPs which are accredited to develop HV overhead lines, it might be sensible to isolate this work from the rest of the HV work and exclude it from the margin.

Unmetered

1.95. All of the respondents representing the interests of unmetered connection customers opposed the implementation of a margin on unmetered works since they do not feel that the prices of these connections are a barrier to competition developing in this area and called for a baseline competition test before any margin should be earned by DNOs. One DNO welcomed the option of an opt-out for the unmetered market where both DNO and Local Authority were in agreement that this was the most effective course of action. One DNO however suggested that DNOs should be entitled to earn an unregulated margin on all PFI work from 1 April 2010 since the elements involved would be fully aware of the competitive options available to them.

What are your views on the proposed level of regulated margin?

Metered

1.96. There was a wide variation of views on the particular level at which the margin should be set. Across most of the DNOs there was a general feeling that in order to provide effective headroom for third parties, the level of margin should be greater than the 4% on contestable directs. Three DNO groups felt that the margin should be applied to the indirect expenditure relating to contestable connections work as well as the direct, since this was how it was explained in the report that Ofgem cited as an influence on setting the margin at 4%. Two other DNO groups felt that any level of margin set would be ineffective if it were to be set anywhere below 8-10%. On the other hand, one DNO opposed to the implementation of margin maintained that they felt there should be no margin applied. Two DNO groups did not directly voice their opinion on exactly which level the margin would be set because they felt that the basis for the calculation was unclear. One of these DNOs went on to say that it would be easier to apply the margin to all contestable works and felt it would be important to get the views of ICPs. An IDNO representative agreed that the level of margin was far too low. Two consumer representatives and an ICP felt that 4% was a reasonable and acceptable level. A consultant felt that the margin should be introduced in 2011 at a much lower level of 1.5-2.5% rising later to 4%.

Unmetered

1.97. The respondents representing unmetered market contractors and customers were of the view that the margin should not be applied to the unmetered market, although one did concede that if it were decided that it should, 4% would be an acceptable level.

Is there any further evidence we should take into account in setting the level of regulated margin?

Metered

1.98. One DNO felt that it was important that relevant contractor margins were taken into consideration and cited it as a reason for allowing margin on indirect connections expenditure. An IDNO representative questioned what Ofgem's viewpoint would be where a 4% regulated margin actually led to a reduction in the charges passed on to customers. Conversely, an ICP representative that felt 4% might be too high explained that they believed that DNOs should pass a year's worth of Guaranteed Standards compliance before earning any margin. Additionally, he suggested that the size of the EHV market as identified in the Impact Assessment looked too small, which would increase the amount of money that could be earned by DNOs from April 2010. A union representative suggested that the return on connections should be similar to core network operations. A representative of the construction industry emphasised that the margin should only apply to direct expenditure and the need for price transparency.

Unmetered

1.99. All of the unmetered customer representatives felt that there should be a baseline competition test that DNOs should pass before any level of margin can be earned and also emphasised the need for as much transparency and accuracy in pricing as possible.

Do you have any comments on the scope of the proposed competition tests?

1.100. Overall, amongst the DNOs there was no clear point of consensus. DNOs were generally of the opinion that the framework needs some additional fleshing out with their representative body and 3 DNO groups emphasising that DNOs should not be penalised for elements outside their control. An IDNO confirmed that they felt that the elements of the tests outlined in the document were satisfactory and covered the main issues. One DNO voiced some concern over certain implied hurdles which would prevent their preference of a test which can be passed immediately. A certain level of cynicism over the current charging methodologies of DNOs led to an unmetered customer representative, an ICP and construction industry representative calling for an improved level of price accuracy and transparency as a key element of the tests. A customer representative voiced strong support for the proposed website click test, where certain key elements of information would have to be a certain number of clicks away from the homepage. The unmetered connection customer representatives explained that the need for independent auditing of DNO performance, more emphasis placed on complaint handling and tests that align between the metered and unmetered markets. An ICP however emphasised that the tests should encourage DNOs to break consensus and demonstrate unique schemes that they have taken on individually rather than evaluating DNO performance against a rigid set of criteria. An area where there was clear disagreement on was the idea that voluntary payments made by DNOs to ICPs in cases where the equivalent of the standards are not met could form a part of the competition tests. ICP respondents felt that this would be a minimum requirement of a DNO aiming to show that it is open to and facilitating competition in connections. DNOs felt that it was unacceptable to be forced to make penalty payments to other companies working under different performance requirements to themselves.

We invite views on the relative weighting of market share compared to the price and service tests

1.101. Amongst all the DNOs there was some confusion over the use of the word "weighting" as they had understood the two-pronged approach of the tests to be of equal weighting. One DNO explained that they felt that the Price and Service element of the tests should be of greater weighting since this was an area that DNOs would have direct control over. An ICP representative suggested that whilst there was room for a price and service test, perhaps the passing of this test should only result in an unregulated margin so as to not disadvantage customers. An IDNO representative suggested that the price and service test should be passed by DNOs regardless of their market share test. One DNO sought clarification that the criteria for DNOs going down the Price and service route would differ depending on their relevant market shares.

What level of lost market share would be appropriate to deem the market competitive?

1.102. The vast majority of DNO respondents were of the opinion that the Herfindahl-Hirschmann index (HHI) score requirement as outlined in the Initial Proposals was completely unreasonable and unachievable. Only one DNO gave a numerical value for where they felt the level of loss market should be, suggesting that a loss of 30% of the market would indicate a competitive market. An IDNO respondent gave a suggested figure of 20% as an acceptable level of market loss whilst a consultant suggested a figure of 40%. An ICP insisted that the only way a market could be defined as competitive is when at least 50% of the market has been lost. A representative of the construction industry suggested that Ofgem should set similar requirements to those developed in the gas market.

Incentives and Obligations – Broad measure of customer satisfaction

Do you agree with the proposed scope of the broader measure?

1.103. All respondents agreed with the proposed scope of the scheme. The following specific comments were made in respect of each component, mainly by DNO respondents (others did not comment on the specifics).

Customer satisfaction component

1.104. Various DNOs made the following points: Surveying customers will present practical challenges and Ofgem should ensure that the benefits outweigh the complexity and costs of surveying these customers; DNOs should receive customer feedback quickly before the customers' recollection fades; 'Recommend' may not be appropriate as an advocacy question and therefore Ofgem should apply alternative suggestions; Survey methodology considerations must include regional bias, sample sizes and those companies that are vertically integrated; No objection to website information being considered as part of the survey; Ofgem should use a market tested measure of advocacy to give credibility and confidence in the incentive; Ofgem should provide further information on how the views of various customer groups will be balanced within the survey and sample sizes.

Complaints metric

1.105. DNOs generally supported the inclusion of an objective measure on complaints and the focus being on complaints resolved rather than complaints received.

1.106. Two DNOs were supportive of focusing the complaints metric on Ombudsman referrals rather than Ofgem determinations (which are a very small proportion of complaints).

1.107. Various DNOs also made the following points: There is a need for a consistent approach to recording complaints and a suggestion that publishing complaints data would provide clarity on this; there is a need for early clarification of the reporting definitions so that business processes & systems can be established; Complaints, although important, provide a lagging indicator of customer satisfaction.

Stakeholder engagement

1.108. Various DNOs made the following comments with regard to measurement of this component: Further clarity on the attributes and measures of success and failure and the process to ensure consistency between DNOs is required; Measurement should be spread throughout the year and should not be an annual event; A communication strategy and plan should be required to show how DNOs address the different needs of audiences and to facilitate two way feedback so that companies understand the impact of their activities; DNOs should be encouraged to keep their engagement activities under review; A satisfaction survey for stakeholders could be used for measurement, possibly as an add-on to the main survey; Measurement should capture what engagement the DNOs have undertaken, the methods they have used, the success of the approach, the impact and scale of delivery of DNOs' efforts as perceived by stakeholders; Measurement should not be based on the size or frequency of events.

General comments

1.109. Respondents suggested that there needs to be consistent reporting of complaints data as companies that are less robust in recording complaints could benefit from faster resolution times.

1.110. One DNO suggestion that the efficient costs of DNOs running the survey should be allowed and estimate £75k per licensee per year.

1.111. Another DNO expects that the pass through costs of the Accent survey will be withdrawn from the current licence.

Do you agree with the revenue exposure and the incentive weightings proposed for each element?

1.112. Most respondents agreed that the 1% revenue exposure was right. One DNO commented that it is difficult to commit to 1% where Ofgem fails to provide appropriate cost allowances in the price control to maintain current levels of performance. Two respondents considered that more revenue should be exposed; one DNO suggesting +1.25/-1.125. Another DNO disagreed with offsetting the downside of the stakeholder engagement component against the other elements and preferred exposure of +1/-0.8% instead.

1.113. Three DNOs considered that the incentive should be less heavily weighted on complaints and more weighted on the customer survey. One customer respondent would like to see the incentive more heavily weighted towards stakeholder engagement, which it sees as a more proactive activity for the DNOs than the other components.

1.114. Other combinations of weighting suggested were:

Survey	0.6%	+0.5/-0.4%	+/-1%
Complaints	0.3%	+0.3/-0.4%	+/-0.125%
Stakeholder engagement	0.1%	+0.2%	+0.125%
Total	1%	+1/-0.8%	+1.25/-1.125%

Incentives and Obligations – Telephony incentive scheme

Do you agree with the proposed improvements to the telephony scheme?

1.115. Most DNOs generally support Ofgem's proposed changes to the telephony scheme. However, one of the DNOs mentioned that they are in support as long as there is a satisfactory measure included for unsuccessful calls. Another DNO suggested there is scope for improvement which should be considered. Only one DNO did not support the proposals to the telephony scheme. They believe that streamlining the attributes will reduce the scope of the information provided by customers and dilute the value.

Do you agree with our proposals and methodology for recasting the reward and penalty thresholds?

1.116. Most DNOs agree with proposals and methodology for recasting reward and penalty thresholds. However one of the DNOs is of the view that the imbalance between penalty and reward is excessive and propose the addition of a graduated reward element. Another DNO suggested that proposed upper and lower bound figures need to be carefully considered before final proposals.

Incentives and Obligations – Worst served customers

Do you agree with the proposed mechanism (in full) for worst served customers?

1.117. All of the respondents, which include six DNO groups and a consumer representative body, stated their support for the introduction of a worst served customer scheme. However, there was no support for the scheme in full from DNOs as three groups felt that there should be a worst served customer allowance provided on an ex-ante basis. Three of which explained that the 25% improvement target should be an aspiration rather than a requirement and two explaining that they saw no reason for an improvement target at all. Another DNO felt that to avoid excess bureaucracy the allowance should be merged with existing opex and capex measures. All but one of the respondents also had some concerns over the level of the proposed caps per benefitting customer.

Do you agree with the level of the proposed cap per benefiting customer? If not, what level do you believe is appropriate?

1.118. One DNO supported the proposed cap per benefitting customer whilst another felt it was sufficient but would not enable DNOs to target the real worst served of customers. Two DNO groups suggested that the cap should be double to allow a wider portfolio of DNO schemes to be feasible whilst a further two felt that there should be no cap applied. The customer representative body that responded felt that £1000 per worst served customer might be insufficient to target those customers most deserving of performance improvements but emphasised the need for a cap to be in place to prevent the disproportionate allocation of resources to the interests of the more vocal stakeholder groups.

Incentives and Obligations – Interruptions Incentive Scheme (IIS)

Do you agree with the proposal that any required improvement from current performance levels should be funded by shareholders?

1.119. Of the DNOs that responded on the proposal, there was no DNO which was in complete agreement with the proposal. One DNO, whilst agreeing that this would be a suitable approach to customer minutes lost (CML) improvements where operational improvements can influence performance, agreed with the assertion from the majority of other respondents, that the proposal would be unsuitable for customer interruption (CI) performance improvements. The DNO view is that shareholder funded investment for CI improvement is inherently biased against DNOs that have a level of improvement to make since shareholders will be funding improvements that have been necessitated by other DNOs making equivalent improvement through customer investment. Another DNO felt that there were inherent weaknesses within the bench-marking target-setting methodology which would make the proposal difficult to accept for practical reasons. Their assertion was that the bench-marking methodology, with its conflation of customers per fault and network fault rates based on the length of circuits would lead to them receiving an unrealistic performance target whilst national fault rates are actually increasing. They also noted that the grouping and comparing of relevant circuit categories within the disaggregated templates was flawed, as evidence suggests that circuits of equivalent properties can differ in performance.

Do you agree with the approach to setting pre-arranged allowances?

1.120. The majority of the respondents felt that the pre-arranged allowances had been derived from an expenditure driver which was not reflective of the categories which were the primary drivers of pre-arranged interruptions. Additionally there was a lack of enthusiasm for the movement away from the yearly cap/collar.

Do you agree with the proposed levels of revenue exposure and incentive rates?

1.121. All DNOs were broadly supportive of the retention of the 3% of revenue exposure, although those companies who had received a difficult CML target were concerned about the readjusting of the relevant CI/CML weighting. With regards to the Incentive Rates, there was a significant concern raised by all the DNOs that responded around the amended incentive rates used in Initial Proposals based around customer willingness to pay and relevant bill size. All felt that the average business customer bill size made the incentive rates excessive and several felt that in combination with the tightening of the bands, the impact of performance would become excessively volatile.

Do you agree with the proposed refinements to the exceptional events mechanism?

1.122. All DNOs were supportive of the move towards widening the scope of one-off events in light of entering a period in which a substantial level of work will be carried out on the network. However, two DNO groups felt that the modifications did not go far enough with one suggesting that there should be an acceptance that all types of construction work could lead to one-off events and the other explaining their disappointment at the lack of grid code inclusions in the wording. Another DNO felt that the amendments would have an neutral impact overall as the benefits of widening the one-off scope would be counter-balanced by the suggested amendments to the severe weather exceptional events criteria requiring the 24 period that would make the event exceptional to occur within the first 48 hours of the event. The DNO argued that this would likely make large-scale floods, where faults amount over time, fall outside of the scope of the mechanism.

Incentives and Obligations – Guaranteed standards (GS) of performance

Do you agree with the proposal to increase failure payment levels to reflect inflation?

1.123. Most DNOs agree that GS payments should increase in line with inflation. One DNO who did not support the proposed changes is of the view that it sends the wrong message to customers. According to the DNO, GS payment is a payment in recognition of the inconvenience to customers and not payment for loss and also inflation is currently at very low values and may not be an effective driver for service provided by DNOs.

1.124. One non-DNO who responded does not support the proposed changes to the guaranteed standards of performance and suggest Ofgem should undertake further work and consultation on the proposed changes.

Do you agree with the proposal to introduce some form of payment cap for large one-off events?

1.125. Most DNOs support introduction of a payment cap for large one-off events. One DNO suggested that the GS should be aligned to the IIS exceptional events category to cover exceptional events affecting large number of customers. It also suggests that rather than a payment cap, the IIS exceptional event rules should be added to the list of exemptions from normal and severe weather standards.

If you agree to the introduction of some form of payment cap, what is your preferred method?

1.126. Most DNOs support the introduction of a payment cap in a way similar to that used in the severe weather event. One DNO would like an event specific cap to be introduced to ensure no individual event carries a GS risk greater than £1m.

1.127. Another DNO would like a payment cap to reflect the financial impact across the whole year and suggest a cumulative annual cap of 2% total company revenue exposure in addition to a limit of £200 per customer.

1.128. Another DNO suggested that payment should be suspended once it exceeds a certain amount.

Do you agree that rota disconnection interruptions should be treated independently of the multiple interruption standard?

1.129. Most DNOs agree that rota disconnection interruptions should be treated independently. One DNO suggested that the powers to impose rota disconnections be accompanied by the suspension of the GS regimes for interruptions.

Incentives and Obligations – Customer Service Reward Scheme

Do you agree with our proposals for embedding DPCR4 best practice?

1.130. Some DNOs agree that best practice should be embedded in the scheme rather than via licence condition to retain flexibility.

1.131. Most DNOs believe that customer service reward scheme is a voluntary scheme and will work best if left as that.

1.132. They suggest that allowing DNOs to retain a degree of independence to implement initiatives that are of real and lasting benefit for their customers, so long as they are able to justify and provide evidence of their actions and benefits will be more effective.

1.133. Only one DNO supported Ofgem's proposal of embedding DPCR4 best practices.

Do you agree that the scheme should be rationalised once the Broad Measure goes live in April 2012? If so, in which areas?

1.134. Most DNOs agreed with the proposal to streamline the reward scheme in 2012. The two DNOs who did not support this suggest there are still aspects of corporate social responsibility and wider communication which will not be covered in the broader measure.

1.135. The DNOs who responded would like to avoid duplication of the broader measure, and for it to reflect areas where DNOs exceed their social obligations and areas of customer service not subject to a detailed incentive scheme or other reporting requirements.

Incentives and Obligations – Network Output Measures

Is our proposed common methodology for network output measures related to general reinforcement and asset replacement expenditure appropriate?

1.136. All respondents welcomed the common methodology set out in Initial Proposals for network outputs related to investment in general reinforcement and asset replacement. Some of the specific high-level issues raised in submissions include:

- The objective of working towards high level 'tier 1' output measures over DPCR5 is fully supported.
- Initially each DNO should retain the freedom to use its own internal processes and set its own thresholds for allocating assets/sites an HI/LI ranking, which means that at this stage it will not be possible to benchmark.
- Use of a five year rolling average fault rate output measure is appropriate, however it must be recognised that this means it will take time for clear trends to be observed.
- One DNO raised significant concerns about the speed with which the framework has been developed, and considers that the links between outputs and investment may not be adequately robust for the measures to be used as a basis for financial penalties.
- The current measures do not align fully with the underlying business processes that are used to plan and operate the network, and further development over DPCR5 will be needed. For example the LI current only focuses on one reinforcement driver (n-1 capacity), while ignoring the other three drivers (P2/6, fault level, voltage limits).
- One respondent has concerns that the outputs measures as currently developed will not permit suitable benchmarking, and hopes that the framework can be quickly evolved to help assess relative DNO performance.

Is our proposed process for determining whether a DNO has performed satisfactorily against its agreed DPCR5 outputs appropriate?

1.137. Respondents generally agreed with our proposed process for assessing output performance, in particular the recognition that new information received over the period will impact performance against the agreed outputs. However one DNO expressed a concern that the proposed annual monitoring of a company's performance signals a move to rate of return regulation rather than the incentive based regulation that is characteristic of RPI-X.

1.138. Some of the specific high-level issues raised in submissions include:

- Annual reporting of outputs will provide Ofgem and the DNOs with a significant opportunity to investigate any apparent trends.
- It may be difficult to be definitive about whether performance has been satisfactory or not. The proposals show that Ofgem is prepared to acknowledge changes in business drivers, available data and asset management methodologies etc that impact on performance over DPCR5.
- A mechanistic 'pass/fail' approach should not be applied to each individual output, rather there will need to be a programme-level assessment of performance against the outputs. It would not be in any party's interest for DNOs to attempt to recover every adverse trend irrespective of cost.
- The LI outputs are highly dependent upon the accuracy of demand forecasts, and it must be recognised that demand forecasts have never been more uncertain (i.e. due to the unknown impact of energy efficiency, DG, economic climate, unknown future demand from electric vehicles, etc).

What approach should be taken if we determine that a DNO has failed to deliver against its agreed DPCR5 outputs? Have we considered all reasonable options to impose financial consequences for under-performance?

1.139. In general, while acknowledging the need to protect customers, most respondents were of the view that it is too early to impose financial consequences for DPCR5, given that the methodology is newly developed and untested. Some of the specific high-level issues raised in submissions include:

- It is unlikely that financial penalties will be required if the process to determine performance is followed, as in the majority of cases where outturn is different to forecast it will likely be a question of timing of investment.
- A number of DNOs suggested that if financial consequences are imposed for DPCR5, an impact statement should be included with FP.
- The option to require DNOs to deliver the DPCR5 outputs 'gap' over DPCR6 was not generally favoured given that the equivalent financial consequences are applied under the other two options.
- A number of respondents suggested that if Ofgem is to impose financial consequences for under-delivery, it will need to carefully consider the alignment of incentives under the IQI mechanism.
- In addition to potential financial consequences, under-performing DNOs should have their DPCR6 capex forecast subject to much greater scrutiny.
- There is a danger that the benefits of the outputs regime could be seriously undermined if Ofgem adopts a target-based approach, which could encourage an inefficient short-term focus at the expense of long term stewardship.
- Consideration should be given to rewards for DNOs who out-perform on their outputs.

Should we apply different treatment to DNOs that fail to deliver the agreed DPCR5 outputs, depending on their level of DPCR5 investment relative to the forecast?

1.140. Generally respondents considered that the treatment of under-delivery on outputs should be invariant to the outturn spend. Some of the specific high-level issues raised in submissions include:

- The mechanism adopted should be calibrated to take into account the relative size of the expenditure and output delivery variances.
- In principle a DNO failing outputs while underspending could be accused of negligent behaviour, whereas a DNO failing outputs while spending its allowance could be considered wasteful. Given that both outcomes have detrimental customer effects it would not seem appropriate to distinguish between them mechanistically.
- There could be many reasons for the outturn spend. An underspend may indicate deferral at the expense of long term asset stewardship, but it may be due to other reasons such as prolonged land issues delaying delivery. An overspend may indicate inefficient investment in some areas, or it may be due to a specific asset issue or greater than forecast deterioration.

Incentives and Obligations - Innovation Funding Incentive (IFI)

Do you agree with our proposal to retain IFI?

1.141. All DNOs and the two non DNO respondents agreed with our proposal – several considered that it has been an effective mechanism during DPCR4 and has successfully encouraged DNOs to carry out research and development.

1.142. The move to a fixed pass-through cost for DPCR5 was seen as sensible.

Do you agree with our proposal to focus IFI on technical R&D, whilst creating the new low carbon network fund for the trialling of low carbon initiatives on the networks?

1.143. All respondents broadly supported the proposals. However some DNOs expressed confusion as to why the new LCN fund has a broader scope than IFI (especially with respect to commercial arrangements), and requested that the IFI scope be similarly broadened. Two DNOs noted that there needs to be clear guidance on the differentiation between IFI and LCN fund projects.

Incentives and Obligations - Equalising incentives and the information quality incentive

Does the 85 per cent capitalisation of all costs within the equalised incentive provide an appropriate speed of money?

1.144. The DNOs are split on this matter. Three DNOs support the proposal, three oppose it and the other DNO has not addressed this question.

1.145. Those that support the proposal note that it grants additional flexibility to DNOs in the way in which they conduct their operations and suggest that the percentage proposed in the Initial Proposals is appropriate.

1.146. The DNOs that oppose the proposals did so primarily on the grounds of concern over financeability and they generally support retaining the status quo. One DNO went further in identifying the following specific reasons for retaining the status quo of a lower capitalisation percentage:

- It provides price signals to customers to encourage efficient consumption decisions
- It encourages more commitment from regulators to recover efficiently incurred costs
- It encourages better regulatory discipline

Does the IQI matrix presented provide an appropriate profile for the incentive strength? Should we be considering an alternative profile with a steeper incentive rate?

1.147. Two DNOs responded that the proposed changes to the IQI mechanism would increase the risk exposure placed on the DNOs. They argued that the increased exposure should be compensated for elsewhere in the DPCR5 settlement.

1.148. Two respondents expressed support for a stronger incentive rate. One DNO expressed the view that the IQI matrix should be asymmetric.

1.149. Several DNOs responded that changing the mechanism at this stage would have a limited effect on the accuracy of forecasts for the DPCR5 period.

1.150. One DNO expressed full agreement with the profile for the incentive strength.

What approach should we adopt when setting the start to earn points of the IQI matrix?

1.151. Several DNOs responded that the IQI mechanism should not be tightened further. One DNO supported the proposed approach fully.

Allowed revenue cost assessment - Overview of our approach to cost assessment

Have we taken an appropriate approach to assessing costs?

1.152. Generally the respondents raised concerns with how the proposed allowed revenues were set. While a number indicated that the process up until Initial Proposals had been robust, they had concerns with an apparently lack of transparency around the models and interpretation of the results.

1.153. A number of DNOs had concerns over the unit costs analysis. They indicated that there was little consultation done on the modelling for this, and they had concerns over the robustness of the results.

1.154. The majority of DNO, were also unhappy with the use of 'lesser of' approach, whereby Ofgem used the lesser of the DNOs or the industries median/average.

What mechanism should be used to fund high value projects?

1.155. There were varying opinions across the DNO as to which of the three options presented by Ofgem would be appropriate. Each option was supported by at least one DNO. However, the majority supported receiving the full amount in an ex ante allowance with an ex post review.

What assumptions do you think we should use for real price effects and ongoing efficiencies for DNOs over the 2010-15 period?

1.156. A number of DNOs argued that Ofgem's productivity assumptions were too demanding. One DNO expressed full support of Ofgem's proposed efficiency improvements.

1.157. The majority of DNOs raised concerns over Ofgem's RPE assumptions. These concerns were focused on the labour RPE assumptions for 2008-09 and 2009-10. Most DNOs also argued for the inclusion of a wage growth premium for specialist labour due to skill shortages in the industry. One DNO argued for a distinction between RPEs for internal and contractor labour. In contrast, a supplier agreed with our approach to capex RPEs but believed that our assumptions for opex RPEs were too generous to the DNOs.

Do you agree with our proposed methods for handling uncertainty?

1.158. The methods proposed for handling uncertainty were generally welcomed.

1.159. Several respondents expressed concern over the risk exposure faced by the DNOs in relation to mechanisms for load-related expenditure and the amount of protection provided by the IQI mechanism. Other suggestions made in relation to methods for handling uncertainty included input price indexation, adjustments to the IQI incentive rate and that DNOs should be allowed to re-open the price control should circumstances change materially (a substantial effects clause).

Are our proposals for volume drivers on low-cost connections involving shared assets proportionate, i.e. is the mechanism necessary?

1.160. The majority of DNOs supported Ofgem's approach of introducing a volume driver for low-cost connections. However, a number indicated that further work needed to be done on the unit costs and they would need to see the autumn update before being able to give an informed decision.

What is an appropriate materiality threshold for the operation of our proposed load related expenditure reopener?

1.161. The respondents generally agreed with the suggested 20 per cent materiality threshold for the load related reopener. A DNO further suggested that there should also be a minimum amount (£10m) before the reopener could be triggered.

Does the GDPCR reopener for TMA costs provide a good template for our final DPCR5 proposals for these costs?

1.162. The general view held by respondents was in support of a reopener for TMA cost, given uncertainties in the magnitude and timing of costs.

1.163. One DNO responded that the gas and electricity distribution industries are too different to apply the GDPCR reopener as a template.

Allowed revenues and financial issues - Cost of Capital

Do respondents think that PwC have identified an appropriate range for setting the cost of capital?

1.164. See section 2 - Core document - Proposed allowed revenues.

How should we balance our standard long-term view of the cost of capital with current indicators in the capital markets?

1.165. Many respondents suggested averages of a longer term than have previously been used should be considered when setting the cost of capital for DPCR5.

1.166. A large number of respondents cited recent factors such as FRS17, which is suggested to have depressed index-linked gilt yields.

1.167. A number of respondents believed that there has been a re-pricing of financial risk following the credit crunch and suggest that recent low historic averages are unlikely to return soon.

1.168. The DNOs responses typically pointed to the analysis conducted by NERA which suggests weighting the WACC to reflect historic and forward looking projections.

Which, if any, of the alternative methods of dealing with variability in the cost of debt should we adopt?

1.169. See - Core document - Proposed allowed revenues.

What are the pros and cons of the mechanistic debt trigger as suggested by PwC?

1.170. See - Core document - Proposed allowed revenues.

Allowed revenues and financial issues - Regulatory asset values (RAV)

Do you agree with the draft rules for computing RAV additions and will they reduce or eliminate boundary issues at DPCR5. If not how should they be amended?

1.171. The majority of the responses came from the DNOs. The respondents generally supported the draft rules and believe they will reduce boundary issues. The main criticisms related to the proposed level of capitalisation.

1.172. One respondent said that while the rules will not eliminate all boundary issues they are a step in the right direction. This respondent also said that boundary issues are still apparent if cost assessment continues to be carried out at a disaggregated level.

1.173. One respondent suggested that the reduction in boundary issues might lead Ofgem to reduce the extent of the cost reporting in the Regulatory Reporting Packs.

1.174. One respondent suggested that while the Total Expenditure (totex) approach reduces boundary issues, some costs should be reclassified from networks to business support.

In what circumstances would you consider it appropriate to have DNO-specific RAV additions percentages?

1.175. The majority of the responses came from the DNOs who generally believed that a fixed percentage for all companies is appropriate.

1.176. However, one respondent said that DNOs are differentially affected by applying a fixed percentage and that this could cause problems when trying to compete for capital.

1.177. A number of respondents said that while fixed percentages should be applied, specific percentages could be used to address short-term financeabilty concerns.

1.178. Two respondents said that DNO specific percentages would reduce transparency.

Allowed revenues and financial issues - Excluded Services

Do you agree with our proposal to bring the distribution of units to new EHV premises, provision of charging statements and reactive energy transportation within the scope of the main charge restriction conditions?

1.179. DNOs support including EHV in the price control so long as re-openers are available for large un-forecast EHV work.

1.180. DNOs support including provision of charging statements in the main price control.

1.181. DNOs support the inclusion of reactive power in the main price control but suggest it is contrary to the objective to reduce losses.

Do you agree that revenue protection services should be exempt from a RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party?

1.182. DNOs agreed with the proposal to exempt revenue protection services from a RAV adjustment where reported revenues exceed forecast revenues.

1.183. Respondents were generally silent on the matter of whether or not the definition should make clear that the service only includes work commissioned by a third party though one DNO did oppose this proposal and instead suggested that all work should be subject to this exemption.

1.184. One respondent also suggested that all sources of information leading to theft detection should be included.

Do you agree with the proposed RAV adjustments for top up and standby, other system charges and metered excluded services where reported revenue (costs in the case of metering) exceeds forecasts?

1.185. DNOs support the RAV adjustments for top-up and standby but oppose adjustments for other system charges and metered excluded services where revenues exceed forecast as it may provide a disincentive to providing these services and exposes DNOs to risk from changes in activity levels.

1.186. One respondent suggested that for ‘Other system charges’ the definition should be widened to include revenue from non-network activity.

Do you agree with our proposals with regard to diversion work in DPCR5?

1.187. DNOs are split on this matter, some support the changes others oppose it.

1.188. Two DNOs opposed the proposals, three supported it and two did not address this question. Those that opposed it did so on the grounds that diversions work is already carried out efficiently and that the proposals give no scope for over or under recovery of overheads.

Do you agree with our proposals regarding metering excluded services?

1.189. DNOs oppose costs in excess of forecasts being deducted from allowed costs as it provides a disincentive to provide these services.

Allowed revenues and financial issues - Corporation tax allowances

Do you agree with our position on the tax methodology?

1.190. DNOs broadly support the tax proposals but:

- suggest that opening written down values should be adjusted to prevent customers receiving the benefit of capital allowances twice
- suggest that DNO averages are not appropriate since DNOs have limited opportunity to manage their pension costs

Do you agree with the proposal to establish a tax trigger mechanism and that we have established an appropriate balance between incentivising DNOs to manage their tax risks and sharing the risks of rewards with consumers?

1.191. DNOs support the introduction of a tax trigger but make several suggestions:

- The scope of the trigger be widened to include the impact of changes in case law, new accounting standards, changes in tax practice as well as changes in tax statutes.
- DNOs agreed that a percentage of regulated revenue would be a suitable threshold and that Ofgem's proposed threshold of 2% is too high. DNOs' suggestions for the threshold ranged from 0.15% to 0.50% of total regulated revenue.

1.192. There was also some disagreement amongst DNOs about whether the trigger should affect the amount in excess of the threshold or the whole amount.

Allowed revenues and financial issues - Revenue allowances and financial modelling

Do respondents agree that we have appropriately identified the scope of the price control, i.e. are we making allowances for the right categories of costs? RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party?

1.193. DNOs agree that Ofgem has appropriately identified the scope of the price control in general terms but have specific reservations. Several DNOs are concerned that the cost of capital may be set too low and that the financeability tests will not lead to a comfortable investment grade. Some DNOs suggested that Ofgem target an A - credit rating for the financeability tests.

1.194. Several DNOs also expressed concern about what they perceive as a lack of potential for outperformance whilst one DNO also suggested that the initial proposals are not sufficiently active in working towards meeting the 2020 carbon commitments and that the operating expense allowances are not adequate.

How do respondents think we should profile allowed revenues over the 2010-15 period?

1.195. All but one of the DNOs agreed that profiling was appropriate but there were a range of suggestions from the DNOs about how revenues should be profiled.

1.196. Most DNOs acknowledged the reasonableness of profiling revenues to match costs, an idea also supported by one customer.

1.197. Other suggestions for profiling included a constant increase in each year and a P0/X approach.

Appendix 5 – Summary of responses to the September update letter

Chapter summary

This chapter summarises the responses received for the Electricity Distribution Price Control Review - September Update to Initial Proposals.

Main document

General comments

1.1. Noting the number of reopeners in the price control, one respondent suggested a time-lag of at least two years prior to implementing price increases from reopeners, in conjunction with a smoothed increase throughout the price control period, in order to reduce the risk for suppliers when pricing for customers.

1.2. Another respondent suggested that all reopeners should be logged-up, including those which benefit the customer, and then closed at the end of DPCR5. This would then be charged during DPCR6 on a Net Present Value (NPV) neutral basis.

Appendix 1 – Network cost assessment

Do you consider the volume drivers proposed for customer demand connections to be appropriate?

1.3. In general, the respondents agreed that the volume drivers were appropriate.

1.4. Some respondents raised concerns that the data provided by DNOs might be inconsistent. They have provided the following reasons for why they believe the data is inconsistent: the different application of connection charge methodologies across the DNOs, the proportion of customer to DNO funded costs being different for each DNO and the sample size used by Ofgem being too small.

1.5. Another respondent raised the concern that DNOs who facilitate competition in connections could be penalised as the current drivers do not recognise the effect of Distribution Network Operator (DNO) to Independent Distribution Network Operator (IDNO) connections. These connections may not be in settlements, may have no Meter Point Reference Number (MPAN) and in a significant number of cases are at a higher voltage than the end customer.

1.6. One respondent suggested it should be possible for DNOs to recover additional costs above the benchmarked unit cost where it can be proved that connections of a complex nature have taken place.

1.7. Another respondent suggested that the method for truing-up at the end of the period should be clarified.

Do you consider the proposed reopener for low volume, high cost connections and general reinforcement appropriate? Is it set at the right level?

1.8. Respondents were broadly in favour of introducing the reopener as it was felt that forecasting in this area would be inaccurate in the current economic climate.

1.9. One respondent mentioned concerns about combining Low Volume, High Cost (LVHC) connections with General Reinforcement within a single reopener due to the variation in costs of LVHC connections. Also, the risk of LVHC connections costs increasing in the event of an economic recovery was mentioned.

1.10. One respondent suggested that the reopener triggers would need amending. They suggested that a trigger based upon percentage of baseline is acceptable for LVHC connections, but the threshold for general reinforcement should be set at 1% of revenue.

1.11. Another respondent suggested the reopener threshold should also have a minimum level (e.g. 20% subject to a minimum value of £10m)

Do you agree with the proposed mechanisms (reopeners/logging-up) for dealing with uncertain costs?

1.12. Most respondents agree with the introduction of a reopener for General Reinforcement and Connections and with the trigger mechanism suggested.

1.13. One respondent suggests that the trigger should be 1% of base revenue for all reopeners.

1.14. Some respondents would like the timing of the reopener to be either more flexible, or to have no time constraints at all.

1.15. One respondent would like the Rising and Lateral Mains reopener to be triggered once a materiality threshold has been reached.

1.16. Most respondents were strongly opposed to the logging-up mechanism for CNI. Respondents argued that the logging-up mechanism should apply to 100% of incurred costs rather than 95%.

1.17. Although some respondents were in favour of the proposed mechanism for TMA costs, one respondent suggested that an ex ante allowance would be more appropriate as DNOs may already be incurring costs.

Do you agree with our proposed methodology for setting flooding expenditure allowances for DPCR5?

1.18. Aside from one DNO, all responded on the issue of flooding. Of the six DNO groups that responded, one was unsatisfied with the 7% cut that had been made by Ofgem as they felt that their proposals had been based on independent flood defence studies. The other DNOs were broadly supportive of Ofgem's findings, although one felt that DNOs faced with higher costs per site would still be penalised under the methodology. One DNO explained that they accepted that the lack of a SEPA report carried out in one of their areas would make it difficult for Ofgem to set an ex ante allowance, but stressed that they should be able to log up the relevant costs during DPCR5.

Other comments

Transmission exit charges

1.19. Three DNOs reiterated their opposition to an incentive on transmission exit charges.

Incremental expenditure to reduce technical losses

1.20. One DNO felt that their capex allowance should be increased to reflect their existing use of low loss transformers.

1.21. Another DNO observed that whilst the loss incentive rate is appropriate for evaluating low loss expenditure, a lower strength rate would be more appropriate for Ofgem's proposed output based incentive. The higher incentive rate increases the risk to DNOs.

1.22. Several DNOs raised questions around how the DPCR5 loss targets would be adjusted to reflect the loss reductions achieved through the allowed expenditure.

Discretionary Expenditure

1.23. One DNO stated that they were disappointed that their proposals for discretionary expenditure had been disallowed, but recognised that the proposals would be suitable for funding under the LCN fund. They stated that they supported this approach as long as it is applied consistently to all DNO proposals.

1.24. Another DNO highlighted that any expenditure funded should be for trials only.

Appendix 2 – Network investment policy

Do you consider our proposals for an application window to be appropriate?

1.25. A number of respondents believe that changes should be made to the proposed application window.

1.26. One respondent believe that a one month window early in DPCR5 is insufficient as this will require a great deal of forecasting of costs for the remainder of the DPCR5 period.

1.27. In the case of load-related investment, another respondent suggested that a second reopener window be opened in March 2013.

1.28. One respondent believe the deadline should be changed to 30 June 2012 to allow for costs to be recovered from April 2013.

1.29. Another respondent proposes an annual reopener call as this allows Ofgem and the DNOs to allocate resources appropriately whilst maintaining the intended flexibility of the mechanism.

1.30. Another respondent questions the necessity of using 12 months data for the TMA reopener and suggests using 6 months data instead.

Do you consider our proposed approach for TMA costs to be appropriate?

1.31. Respondents were divided as to whether the approach for TMA costs is appropriate.

1.32. One respondent who agreed with the approach still feels that there is some uncertainty surrounding the number and type of inspections to be included.

1.33. One respondent proposed that allowances for all DNOs should be set assuming 90% of noticing penalties paid at discounted rates to give some incentive for outperformance.

Do you consider our proposals for assessment of the load related reopener to be appropriate?

1.34. Most of the respondents consider the proposals to be appropriate although there are still a number of issues which they would like to see resolved.

1.35. One respondent expressed concerns about the general application of a 20% reopener threshold trigger which may not be appropriate due to the different circumstances of each DNO. Some respondents suggested a threshold of 1% of base demand revenue would be a fairer method of determining the reopener trigger.

1.36. Some respondents disagreed with limiting the application period to a single month at the end of the second year due to cost uncertainty. One respondent suggested the option of two windows for applying for a reopener during DPCR5.

1.37. It was suggested by one respondent that a true-up be held in DPCR6.

1.38. Another respondent feels that there are still a number of questions surrounding the scope and definition of the reopener process, and would like further consultation to be held.

Appendix 3 – Finance

General comments

1.39. Only one DNO addressed financial issues in any detail in their response to the September update. The comments they raised are summarised as follows:

Model

1.40. Modelling errors were noted and it was suggested that revenue profiling should follow the treatment in DPCR4.

Pensions

1.41. The DNO suggested that: the reduction in deficits overstated the improvement in market conditions; it is inappropriate to apply the IQI sharing factor to ongoing pension costs; PPF levies and admin costs had not been fully funded in 08/09 and 09/10. Calculational errors were also noted.

Cost of capital

1.42. It was suggested that transaction costs should be reflected in the cost of capital and the continued use of a working assumption figure was objected to.

Excluded services

1.43. Clarifications were sought regarding the treatment of op-up and standby and enhanced system security.

RAV

1.44. It was suggested that no adjustment is necessary in respect of ESQCR in the RAV roll forward and that costs should be treated in the same way as any other cost allowance.