To distribution companies,
consumers and their
representatives,
investors, and
other interested parties

Promoting choice and value for all gas and electricity customers

Our Ref: 62/11
Direct Dial: 020 7901 7194
Email: Rachel.Fletcher@ofgem.gov.uk

Date: 17 May 2011

Dear Colleague,

Open letter consultation on equalising the efficiency incentive rate for electricity distribution network companies under common ownership following PPL's purchase of E.ON's Central Networks business

PPL completed the purchase of two electricity distribution networks (DNOs), Central Networks East and West, in April 2011. This means that PPL UK Resources Ltd now owns four DNOs as it already owned the two Western Power Distribution (WPD) networks in the South West and South Wales. This letter consults on the approach we will use to equalise the efficiency incentive rate across the four DNOs now under shared ownership. Equalising the efficiency incentive rate is necessary in order to remove any undesirable incentives to allocate more expenditure to the DNOs within an ownership group with the weakest rate.

Background: the efficiency incentive rate and DPCR5

At the last electricity distribution price control review (DPCR5) efficiency incentive rates were set for all 14 DNOs. The efficiency incentive rate determines what proportion of any under- or over-spends relative to the regulatory settlement gets shared with consumers. For example, an incentive rate of 47 per cent will mean the DNO gets to keep 47 pence of every £1 that it under-spends and the remaining 53 pence gets passed onto consumers in reduced charges (on a net present value basis). The incentive is symmetrical, ie if the DNO over-spends they must fund 47 pence of every £1 of over-spend and the consumer funds the remainder through increased charges.

The efficiency incentive rate was set at DPCR5 as part of the information quality incentive (IQI). The purpose of the IQI is to incentivise the provision of good quality information within the DNOs' business plan submissions. It takes Ofgem's baseline assumption of the cost elements included in the IQI (the majority of costs are subject to the IQI), and compares these to the forecasts provided by the DNOs. The DNO:Ofgem ratio is then used as an input into the IQI and an efficiency incentive rate for each DNO is calculated. Further details of the calculation can be found in the DPCR5 Final Proposals.[1]

Where DNOs have shared ownership the efficiency incentive rate is the same across each of the networks in the group. The methodology to create an equalised rate treats the DNOs under shared ownership as one group and sums the Ofgem baseline costs for all DNOs in the group and compares to the sum of the DNOs' forecasts for each DNO in the group. This ratio is then used as an input into the IQI and a combined efficiency incentive rate is calculated.

[1] http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_2_Incentives%20and%20Obliaions%20FINAL.pdf

Ofgem's merger policy

We set out in May 2010 our policy on mergers.[2] It superseded our previous statement in October 2005.[3] Within the 2010 publication we stated that our policy of equalising the efficiency incentive rate would remain. It is therefore necessary to equalise the rates that currently apply to the four DNOs owned by PPL.

This new efficiency incentive rate would only apply from April 2011, ie for the four remaining years of DPCR5. In line with our merger policy we do not propose to make any changes to allowed revenues following the mergers.

Options for setting the equalised incentive rate

Currently an efficiency incentive rate of 47% applies to WPD's East and West Midlands DNOs and a rate of 51% applies to WPD's South West and South Wales DNOs. There are a number of options available in setting a common efficiency incentive rate. We discuss each one in turn below.

1) Apply the lower rate

The rate could be set equal to the lower of the current rates. In this case the rate would be 47%. If the four DNOs within the group collectively under-spend then the consumer will be better off as they will get a larger share of the under-spend than a higher rate would give them. But the lower rate may reduce the DNOs' incentive to find efficiency savings and outperform their cost allowance due to a larger proportion of the savings being shared with consumers.

2) Apply the higher rate

The rate could be set equal to the higher of the current rates. In this case the rate would be 51%. If the four DNOs within the group collectively over-spend then the consumer will be better off as they will face a smaller share of the over-spend than if the rate was lower.

3) Recalculation of the IQI to give a new rate

A new rate could be calculated based on the method used at DPCR5 for calculating the efficiency incentive rate for DNOs under shared ownership. In this case the rate that would apply for WPD's four DNOs would be 49%. Details of the calculation can be found in the annex.

Our initial view

We think that calculating a new rate, as per option three above, strikes an appropriate balance for the following reasons:

- Consumers' exposure to any under- or over-spends across the four DNOs does not really change as a result of this decision which ensures that their interests are protected.
- The overall strength of the efficiency incentive remains the same which ensures that management remains incentivised to deliver efficiency savings.

We view this decision as a tidying up exercise to avoid any distortion of incentives between the DNOs in a group. It is not intended to claw back any further benefits resulting from the merger – we think this is in line with our published merger policy.

[2] http://www.ofgem.gov.uk/Networks/Policy/Documents1/Merger%20policy%20statement.pdf
[3] http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR4/Documents1/11703-Elec%20Dist%20Mergers%20061005.pdf

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

As part of changing the efficiency incentive rate for the four DNOs a modification will need to be made to the charge restriction conditions of the electricity distribution licence. Charge restriction condition (CRC) 18 refers to the efficiency incentive rates within Part I and Appendix 1. Following our decision we will issue a statutory consultation to make the required amendment.

Views invited

We welcome views on the options outlined for setting the efficiency incentive rate for the four DNOs now under shared ownership, or any further options we should consider. In particular, we would welcome views on the following questions:

1. Do you agree with our approach to equalise the efficiency incentive rate to 49 per cent for the four DNOs now owned by PPL? If not, please explain why.
2. Are there any arguments in favour of one of the options that we have overlooked?
3. Are there any other options that you think we should consider?

Responses to this consultation should be received by **29 June 2011**. Please email responses to Joanna.Campbell@ofgem.gov.uk. Unless clearly marked as confidential, responses may be published on our website. If you have any queries in relation to this consultation please contact Joanna Campbell on 020 7901 7094.

Yours faithfully,

Rachel Fletcher
Partner, Distribution

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Annex – Calculation of the equalised efficiency incentive rate

As per option three for calculating an efficiency incentive rate for the four DNOs now under shared ownership, we would take the Ofgem baseline and DNOs' forecasts in Table 1.1 below.

Table 1.1 Expenditure for the DPCR5 period (£millions in 2007-08 prices)

DNO	DNO Forecast	Ofgem Baseline	DNO:Ofgem Ratio
CN West	1059.2	986.8	107.3
CN East	1054.6	1023.9	103.0
WPD S Wales	420.3	431.8	97.3
WPD S West	628.6	646.6	97.2
Total	3162.7	3089.1	102.4

Source: DPCR5 Final Proposals

The DNO:Ofgem ratio for the group is therefore 102.4. This is used as an input into the IQI matrix set out in Table 1.2.

Table 1.2 DPCR5 IQI matrix

Ratio of forecast to baseline	95	100	105	110	115	120	125	130	135	140
Incentive rate	0.53	0.50	0.48	0.45	0.43	0.40	0.38	0.35	0.33	0.30
Allowed expenditure	98.75	100.00	101.25	102.50	103.75	105.00	106.25	107.50	108.75	110.00
Additional income	3.09	2.50	1.84	1.13	0.34	-0.50	-1.41	-2.38	-3.41	-4.50
Actual expenditure										
90	7.69	7.50	7.19	6.75	6.19	5.50	4.69	3.75	2.69	1.50
95	5.06	5.00	4.81	4.50	4.06	3.50	2.81	2.00	1.06	0.00
100	2.44	2.50	2.44	2.25	1.94	1.50	0.94	0.25	-0.56	-1.50
105	-0.19	0.00	0.06	0.00	-0.19	-0.50	-0.94	-1.50	-2.19	-3.00
110	-2.81	-2.50	-2.31	-2.25	-2.31	-2.50	-2.81	-3.25	-3.81	-4.50
115	-5.44	-5.00	-4.69	-4.50	-4.44	-4.50	-4.69	-5.00	-5.44	-6.00
120	-8.06	-7.50	-7.06	-6.75	-6.56	-6.50	-6.56	-6.75	-7.06	-7.50
125	-10.69	-10.00	-9.44	-9.00	-8.69	-8.50	-8.44	-8.50	-8.69	-9.00
130	-13.31	-12.50	-11.81	-11.25	-10.81	-10.50	-10.31	-10.25	-10.31	-10.50
135	-15.94	-15.00	-14.19	-13.50	-12.94	-12.50	-12.19	-12.00	-11.94	-12.00
140	-18.56	-17.50	-16.56	-15.75	-15.06	-14.50	-14.06	-13.75	-13.56	-13.50
145	-21.19	-20.00	-18.94	-18.00	-17.19	-16.50	-15.94	-15.50	-15.19	-15.00

Source: DPCR5 Final Proposals

Using 102.4 as the input into the IQI matrix gives an efficiency incentive rate of 49%.

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