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

*Promoting choice and value for all gas and electricity customers*

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Dear Colleague,

**Decision 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, who already own two electricity distribution networks (DNOs) (WPD South Wales and WPD South West), completed the purchase of Central Networks East and West DNOs in April 2011. We consulted in May 2011 on the approach to be used to equalise the efficiency incentive rate across the four DNOs now under shared ownership.

This letter outlines our decision on the efficiency incentive rate that will now apply across all four DNOs. We have decided to recalculate the information quality incentive (IQI) to give a new rate as per our initial view set out in the consultation. The reasons for our decision and stakeholders' responses to the consultation are set out below.

## Summary of our consultation

*Background*

The efficiency incentive rate determines what proportion of any under- or over-spend relative to the regulatory settlement is shared with consumers. For example, an incentive rate of 47% means the DNO gets to keep 47 pence of every £1 that it under-spends and the remaining 53 pence gets passed on to consumers in reduced charges (on a net present value basis).

At the last electricity distribution price control review (DPCR5) efficiency incentive rates were set for all 14 DNOs as part of the IQI. DNOs under shared ownership were set the same efficiency incentive rate. This is to avoid any incentive on the owner to allocate more costs to the DNO with the weakest efficiency rate. The same principle means that when two ownership groups merge, we need to set a single rate to apply across the new merged entity.

In May 2010 we published our updated position on how we would treat any future mergers of network companies.[1] We stated that our policy of equalising the efficiency incentive rate would remain but no other steps would be taken to reduce allowed revenues in the form of a merger tax.

[1] http://www.ofgem.gov.uk/Networks/Policy/Documents1/Merger%20policy%20statement.pdf

*Options for setting the equalised incentive rate*

In our consultation letter we set out three options for how the efficiency incentive rate could be equalised. We stated our initial view that option three should be applied. Below is a summary of the three options.

*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 any 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 to this letter.

**Our decision**

We received six responses to our consultation which are published on our website.[2] The majority of responses supported our initial view that a new efficiency incentive rate should be calculated based on option three set out above.

One respondent, Electricity North West (ENW), thinks the new rate should be set equal to the lower of the two rates which in this case is 47%. They suggest that our initial view should be considered further to ensure that customers are compensated for the loss of a comparator. In our May 2010 merger policy statement we stated that we think this is an area for the merger authorities to consider rather than for Ofgem. Therefore we have not taken this factor into account in coming to this decision.

ENW also state that if we adopt a hybrid rate, as per option three, consumers will get less of the benefit from any savings made by the former Central Networks DNOs (where they argue savings are more likely) as well as an increased exposure to risk in the original WPD DNOs (where they argue that over-spends are more likely due to the relatively efficient bid they submitted at DPCR5). We do not share this view for a number of reasons:

- It is not obvious that there is greater scope for outperformance of the DPCR5 settlement by the former Central Networks DNOs. This is because we do not set expenditure allowances at the levels submitted in the DNOs' business plan submissions and instead use benchmarks such as the upper-quartile.
- It is not certain how the remainder of DPCR5 will unfold so there could be under- or over-spends by the merged DNOs. This means that it is not certain which efficiency incentive rate will be most advantageous to consumers. Nonetheless, we do not think it is appropriate to use this equalising incentive rates decision as an opportunity to claw back further potential savings for customers beyond those agreed at the price control review which is compatible with our published merger policy.

[2] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Open%20letter%20-%20Incentive%20rates.pdf&refer=Networks/ElecDist/PriceCntrls/DPCR5



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- We are also aware that there is a trade-off between setting a weaker efficiency incentive rate (which passes more benefit of under-spends back to consumers), and the incentives on management to make improvements (which are shared with consumers).

In its response National Grid Gas Distribution agrees with the principles behind the approach to equalise the efficiency incentive rates but stated that there could be disadvantages for the distribution network company from adopting the approach as per option three. They acknowledge that the materiality of this will depend on the relative strength of each DNO during Ofgem's benchmarking, when the efficiency incentives were originally set, and the strength of the incentive applied.

Having considered these responses we have concluded that option three remains the most appropriate approach. We consider that our approach strikes the correct balance by ensuring that consumers' exposure to under- or over-spends by the group are maintained while keeping the incentive for the DNOs' management to achieve further savings over the remaining four years of the price control. As we stated in our consultation, we see this decision as necessary in order to avoid any distortion of incentives between the four DNOs.

Our decision is therefore to recalculate the efficiency incentive rate, as per option three above, for the four DNOs now owned by PPL. The annex to this letter sets out the details of the calculation. The new rate of 49% will apply to the four DNOs from 1 April 2011. The original efficiency incentive rates, as set at DPCR5, will apply to under- or over-spends in the financial year 2010-11.

**Next steps**

We will, in due course, issue a statutory consultation on the licence modifications required for the four DNOs' licences affected by this decision. This is necessary because part of the electricity distribution licence, Charge Restriction Condition (CRC) 18, makes reference to the efficiency incentive rate.

The new rate will also be an input to the Regulatory Asset Value (RAV) rolling incentive when it is settled at the end of DPCR5.

Please contact Joanna Campbell (joanna.campbell@ofgem.go.uk) if you have any queries regarding this letter.

Yours faithfully,

**Rachel Fletcher**
**Partner, Distribution**
**Signed on behalf of the Authority and authorised for that purpose**



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## Annex – Calculation of the equalised efficiency incentive rate

As per option three, we calculate an efficiency incentive rate for the four DNOs now under shared ownership using the following methodology.

We take Ofgem's baseline and the DNOs' forecasts as per DPCR5 Final Proposals.[3] These are set out in Table 1.1 below for the four DNOs now owned by PPL.

**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% for the four DNOs.

[3]Page101:http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=370&refer=Networks/ElecDist/PriceCntrls/DPCR5



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