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Rachel Fletcher
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29 June 2011

Dear Rachel

Open letter consultation on equalising the efficiency incentive rate for electricity distribution network companies under common ownership

Many thanks for the opportunity to respond to the above consultation. We recognise that this represents the first test of Ofgem's revised merger policy. Ofgem's assertion is that the revised policy will (through the use of the efficiency sharing factor) deliver merger benefits and protection for current and future customers.

The debate on the equalisation of the efficiency sharing factors must recognise why they were significantly different at DPCR5. Central Networks (CN) business plans submitted a relatively inefficient plan with more (perceived) scope for savings and carrying less risk (in terms of cost or volume shocks). The IQI mechanism recognised this and position by awarding lower efficiency retention rates to ensure that customers benefited from the savings. In comparison, the Western Power Distribution (WPD) business plans were considered to be comparatively more efficient with less scope for savings and carrying more risk.

Following the purchase of CN by WPD's parent company, you have suggested (in line with your public statements on mergers) that the incentive rates of both groups should be equalised to ensure that any inappropriate incentives to move costs across the businesses are removed. Whilst we support the principle, we disagree with your preferred approach (to use a hybrid equalisation rate). Ofgem's three options (applying WPD's incentive rate, CN's rate or a hybrid rate) should be considered carefully to ensure that customers receive appropriate compensation from the acquisition and the loss of a network comparator for Electricity Distribution.

We suggest that Ofgem's preferred approach to recalculate the IQI efficiency rate represents a negative outcome for customers. Adopting the hybrid rate will have the following impact on each of the network businesses.

	CN		**WPD**	
	Company	*Customer*	*Company*	*Customer*
DPCR5	47%	53%	51%	49%
Hybrid rate	49%	51%	49%	51%

The impact of the equalisation at the hybrid rate is that customers receive a reduced percentage of the savings from the CN businesses (which are the most likely networks to achieve the savings) and are exposed to an increased percentage of risk in the WPD networks (which are more likely to be exposed to overspend due to the efficient bid).

This policy potentially improves the available returns and reduces the risk profile of the group at the expense of their customers. We suggest that under these circumstances, recalculating the IQI rate would not represent the spirit of Ofgem's merger policy.

We also do not believe that it would be appropriate to apply WPD's DPCR5 efficiency sharing rate to the entire group given the scope to outperform the CN business plans (as recognised in the DPCR5 IQI mechanism).

We therefore conclude that the most appropriate treatment would be to equalise the incentive rate at the CN IQI rate to ensure that customers receive the financial benefits which they signed up to at DPCR5 and from the loss of a comparator in future relative efficiency modeling.

I hope these comments are useful. Please contact me if I can be of any further assistance.

Yours sincerely,

Sarah Walls

Sarah Walls
Head of Economic Regulation