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Dear Andy

Consultation on the customer satisfaction survey incentive rate term

Thank you for the letter outlining your minded-to position on the customer satisfaction incentive rate scaling terms. As you will be aware, Electricity North West has put significant resources into understanding the consequences of the operation of this very important incentive. Consequently, we are well placed to comment on your proposal.

Do you agree with the high-level principles used to inform the Authority's "minded to" position? If not, why?

Electricity North West was involved in the development of the high level assessment criteria and agrees that these are important principles that should be considered in the development of all incentives. It is unfortunate that the customer satisfaction element of the Broad Customer Satisfaction incentive has been designed in such a way as to make fully meeting all four objectives difficult.

Do you agree with the Authority's "minded to" position? If not, why?**Are there any arguments in favour of one of the options that you think we have overlooked?**

Given the tensions between the four high level principles in the case of this incentive, it has been necessary to optimise achieving them as best as is possible. These tensions arose because of the constraints created by introducing an incentive into the Final Proposals without understanding the data that would be used to assess performance.

Having undertaken the trial of the customer satisfaction survey, it is clear that a number of data issues will make the application of this incentive term difficult, including:

- Difficulty obtaining sufficiently large samples to ensure appropriate statistical robustness particularly for connections samples
- Significant variability in DNO scores month by month, particularly where sample sizes are small

Now that data is available from the trial survey, it is possible to understand how the licence algebra is used to determine incentives. Our analysis confirms the results of your team that:

- The incentive designed at the DPCR5 review risks inappropriately differentiating between companies of very similar performance, particularly around the mean
- It is impossible to reduce the impact of inappropriately differentiating between companies without significantly reducing the incentive power

Overall, we agree with your proposal to use 1.75 standard deviations to determine the scaling factor. This decision has required compromises. It is a shame that the biggest compromise has been a reduction in the power of a very important incentive.

We assure you that we will continue to treat customer service with the importance it deserves despite the likelihood that rewards will be lower than we expected when we accepted the Final Proposals.

Do you agree that the incentive rate term should be fixed for the remainder of DPCR5?

When incentive schemes have been introduced in the past, we have generally seen a narrowing of the range of DNO performance as the incentive becomes embedded. As the range converges, standard deviations will also reduce. If the factor is determined by formula, in this circumstance it would lead to smaller scaling factors in later years – increasing the risk that very similar performance leads to different incentives.

For this reason, we recommend that Ofgem should direct that specific numbers are used for the scaling terms (V_t , X_t , Y_t and Z_t) and that they are fixed for the 3 remaining years of DPCR5.

Consequences for the future incentives

Incentives represent important components of price control packages for customers, stakeholders and investors. It is essential that we learn the lessons of the design of the customer satisfaction incentive and apply that learning to the development of incentives for RIIO-ED1.

Incentives must reward companies for improving performance in areas that customers and stakeholders value. To achieve this, any incentive mechanism needs to pass five tests:

- Is the desired output clearly measurable?
- Is performance controllable by companies?
- Is the mechanism suitable for the objective?
- Is the incentive rate reflective of the externalities?
- Is the rate adequate to drive the desired behaviours?

Our experience of considering how best to implement the DPCR5 incentive leads us to two very important conclusions

- It is inappropriate to develop incentive schemes without an understanding of the data that will be used to assess performance and calculate targets, rewards and penalties. It is also important to understand whether data will be available that is sufficiently statistically significant to use to differentiate between different companies' performance. We must therefore be collecting data now for any new ED1 incentives.
- Targets based on relative performance can have unintended consequences. It is much more appropriate to set fixed targets (if appropriate with lagged annual target increments) to avoid inappropriately differentiating between companies at the mid- range of performance. This would also improve the strength of business cases for companies

responding to the incentive. Targets should be based on an informed understanding of latest performance.

Our customer and stakeholder engagement shows that expectations of DNO performance continue to rise. As a consequence, we expect strong incentives for customer service to be an important feature of the RIIO-ED1 price control. Our experience of the trials of the customer satisfaction and complaints management elements of the incentive lead us to recommend the following improvements to the Broad Customer measure for RIIO-ED1:

- Customer satisfaction
 - Review customer segments and weighting to avoid calculating the incentive using statistically insignificant sample sizes
 - Move to absolute targets (based on observed performance) to avoid inappropriate differentiation between companies on either side of the mean
- Complaints
 - Measure management of absolute volumes of complaints per customer rather than percentages of complaints received to remove current extreme effect of “ombudsman finding” term
 - Move to absolute targets (based on observed performance) to avoid inappropriate differentiation between companies on either side of the upper quartile

We will continue to work with your team to develop and test an approach for measuring the stakeholder engagement element of the incentive scheme. As the scheme goes live in less than 3 months, this trial is increasingly urgent. It is unacceptable that companies still have no clear visibility as to how this element of the scheme will be assessed.

We are keen to work with your team to explore how incentives should be designed to meet the expectations of customers, stakeholders and investors over the RIIO-ED1 period. I will ask my PA to schedule some time for us to discuss how our teams should work together on this very important topic.

If you have any questions regarding our response please do not hesitate to contact me.

Yours sincerely,



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Customer Strategy & Regulation Director
Electricity North West

cc Stephen Perry
James Veaney