



Splitting the major connections incentive

Discussion pack

26 March 2013

The policy headlines for major connections have now been set

- Incentives for delivering good customer service to major connections customers in the RIIO-ED1 period will depend on two strands:
 - Where effective competition has developed, the market should provide appropriate signals
 - Where effective competition has not yet developed, the incentive on connection engagement (ICE) will encourage good service via a potential penalty following an evaluation of DNO performance
- This discussion pack focusses on the potential penalty for the ICE; the current policy status in this area is set out below.

Size of potential penalty	Confirmed: 52 basis points on RORE, converted to £m
Individual treatment of market segments	Confirmed: market segments assessed independently, with a potential penalty defined for each
Approach to splitting the potential penalty	Subject to consultation: two obvious options, either equal split between segments, or proportionate split based on market value

On the potential penalty, only the approach to splitting it is still left to resolve

Previous discussions in working groups revealed differences of opinion over how the potential penalty should be split

- Several potential approaches have been discussed at the connections working group, including:
 - An equal split across the nine relevant market segments
 - An equal split across sub groupings of market segments
 - A split based on approximate market value of the segments
 - A split based on numbers of customers in each segment
- The working group meetings have revealed varying opinions on these options:
 - Northern Powergrid has favoured a value based split
 - Several other DNOs prefer an equal split

Northern Powergrid believes penalties should be proportionate to the scale of the market

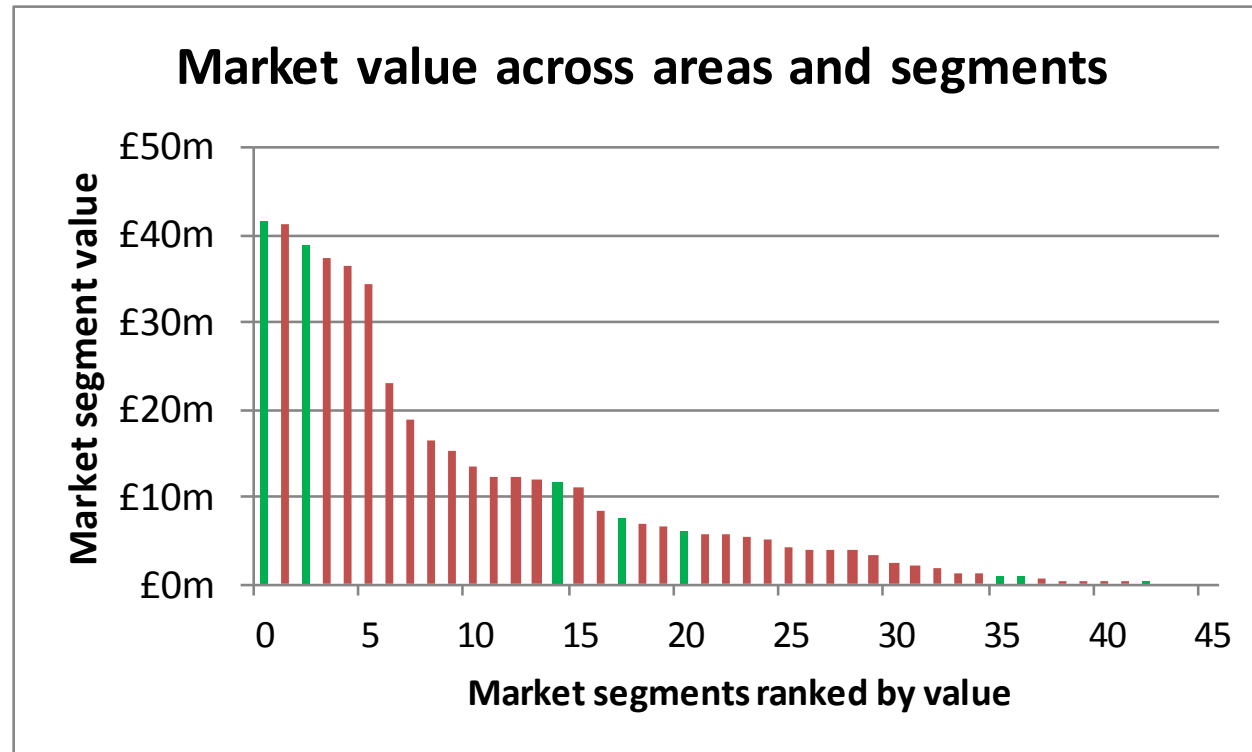
- Northern Powergrid believes that a value based split has significant advantages because it ensures incentives are proportionate to the market they are aimed at
- Ofgem has chosen to make the ICE penalty only:
 - This means that companies have no incentive to fail the competition test
 - But its penalty only nature also creates a positive incentive for companies to pass the test, beyond those they already have
- The larger market segments by value are the ones where, all else taken held constant, competition can bring the most value to customers, simply because there is more customer money at stake
- It therefore follows that the biggest incentive to pass the test should be placed on the largest market segments
- And even if competition is *never* going to develop in a particular market segment, it is still likely that the customer value from receiving good service is likely to be largest where the market value is highest

But to date other companies have tended to favour an equal nine way split

- Other companies have tended to argue that an equal split would be appropriate.
- The main critique, as we have understood it, is that:
 - any fixed value based split would be based on historic data
 - as a result, it would never be 'right'
- This critique is undeniably true of a fixed value based split, where the value of the various segments may change markedly over the price control period as the connections market recovers from the recession...
- ... but it also applies to an equal nine way split, and will be even be worse in that case, since that type of split is even less likely to equal the true value split in any given year...

The market segments we are talking about are anything but equal

- The chart below summarises the available data on market value in different market segments
- The largest segments have about 200 times the value of the smallest



Key: Green bars represent segments that have passed the competition test. The other segments have either not yet been judged by Ofgem, or have failed the test to date
Note: The data is for 2011-12 and has about 35% coverage by number of segments

An equal nine way split of the penalty would not be proportionate...

- The total penalty is set at 52 basis points of RORE exposure, and will be converted to a £m figure
- Splitting this equally nine ways would leave each market segment exposed to the same potential penalty in £m terms – regardless of their size
- How the potential penalty is split determines the incentives DNOs have to ensure competition develops:
 - An equal nine way split would encourage companies to devote no more effort in helping competition develop in one of the big market segments, where the potential consumer benefits are higher, compared to one of the smaller market segments
 - A value based split would ensure the DNOs devote proportionate effort to helping competition develop based on the consumer benefit (by value) that competition could bring in any given segment
- An equal nine way split could also drive perverse outcomes in the service customers receive
 - In a segment facing a relatively low exposure, relative to the scale of the segment, the DNO may not face enough incentive to drive better customer service
 - In a segment facing relatively high exposure, relative to the scale of the segment, the DNO may have an incentive to 'gold plate' its customer service, which could prevent competition developing
- By driving DNOs to place a different emphasis on the importance of customers in different market segments, an equal nine way split could also lead to some customer groups being left behind in terms of the service they receive – something which would not be true of a value based split

...in the HV market segment, Ofgem may have little ability to incentivise competition test passes or better service...

- The HV market segment is one of the larger market segments, by the value of work undertaken
- A potential penalty split equally nine ways could therefore:
 - Give a weak incentive to pass the competition test, despite big potential customer benefits; and
 - Give weak incentives for good customer service where companies have not passed the test
- The data for this segment in 2011-12 is shown below
 - 52 basis points of RORE split equally nine ways could be under 1% of the market value
 - This issue will become even more acute when the housing market recovers, since the same penalty would be spread even more thinly over a higher value of the market

HV demand segment	Market value	Penalty split equally nine ways	
		Financial exposure	Measured as a percentage of market value
EPN	£36m	£0.42m	1.1%
LPN	£37m	£0.29m	0.8%
SPN	£17m	£0.26m	1.6%
ENWL	£15m	£0.30m	2.0%
SHEPD	£19m	£0.19m	1.0%
SEPD	£41m	£0.40m	1.0%
Northeast	£39m	£0.21m	0.5%
Yorkshire	£41m	£0.27m	0.6%

...while in other market segments, incentives to avoid a penalty may be too strong

- Other markets segments are relatively small compared to demand HV work
- In these segments, a potential penalty split equally nine ways could give DNOs:
 - An incentive to pass the competition test that is stronger than justified by customer benefits; and
 - If they *can't* pass the test, give customer service that is so good it risks stifling competition
- The data for 2011-12 for the EHV with lower voltage demand market segment is shown below
 - For some DNOs, the potential penalty is almost half of the total value of work in that segment
 - For others, in parts of the country where this market segment is currently much larger, the potential penalty would be as little as 1% of total market value

EHV & lower voltage demand segment	Market value	Penalty split equally nine ways	
		Financial exposure	Measured as a percentage of market value
EPN	£34m	£0.42m	1%
LPN	£13m	£0.29m	2%
SPN	£6m	£0.26m	5%
ENWL	£3m	£0.30m	9%
SHEPD	£0.5m	£0.19m	41%
SEPD	£6m	£0.40m	7%
Northeast	£0.5m	£0.21m	45%
Yorkshire	£0.0m	£0.27m	Infinite

Splitting the potential penalty proportionately with the value of each market segment would avoid these problems....

- If the total potential penalty were split in proportion with the market value in each segment, then DNOs would face a proportionate incentive to pass the competition test;
 - There would be a bigger 'reward' in terms of the avoided risk of a penalty where the most customer value is at stake
 - This would also be where the potential benefits from competition are largest
- They would also face a proportionate incentive to deliver good customer service in each market segment
 - In the big market segments, where most work (by value) is undertaken, Ofgem would have a tool for incentivising good service that reflects the value of work at stake for customers
 - In the much smaller market segments, the tool Ofgem has would still reflect that value at stake for customers, but be a proportionately smaller £m amount
- For Northern Powergrid, a split of the 52 basis points of RORE based on market value would leave each market segment exposed to potential penalties in the region of 4% of the connections market value at stake
- We do not have a complete market value dataset for any other DNO, but based on the data publically available, the exposure would typically lie in the 4-5% range

...and estimating market value annually should not be beyond us

- DNOs have access to a rich dataset on connections activity in their own distribution service area:
 - The DPCR5 licence, and the ability to earn a regulated margin of 4%, means that consistent monitoring and reporting of the value of work undertaken by DNOs has already been introduced
 - DNOs also know about all connections made to their network by other connections providers, split by market segment, and should know relevant details that might indicate the value of work at stake
- It should be possible to agree on a standard methodology for calculating the value of the work involved in connections being made by other providers in any given market segment
 - This could either use a generic industry set of assumptions, based on an industry wide 'typical' value of the cost involved in delivering a certain 'size' of connection for the market segment in question
 - Or it could be based on DNO specific data, to reflect regional differences in the type of connections undertaken, based on the DNO's historical average DNO cost per connection in that market segment
- Four of the six DNO groups have now published estimates of the total value of the market segments covered in their competition notices – we should be able to develop a consistent approach
- And this would not expose us risks of a different type from those we are used to:
 - The value exposed in the DPCR5 period to Ofgem's ability to claw back allowed margin already fluctuates from year to year
 - We would know the target we must hit in advance to avoid a penalty (the engagement standards set out in the ICE)

Conclusions

- Effective competition should provide an incentive for DNOs to deliver good service to major connections customers, but where it is absent a regulatory incentive can mimic its effects
- The policy of removing the potential penalty from segments that have passed the competition test is therefore correct – it encourages DNOs to help competition develop, and in the event it cannot, gives Ofgem a tool to encourage better service
- But the financial value of the total potential penalty still needs to be split between segments
- An equal nine way split of the potential penalty could drive perverse outcomes and leave Ofgem with a tool which does not balance the interests of all connection customers equally:
 - In a segment facing a relatively low exposure, compared with the scale of the segment, the DNO may not face enough incentive to pass the competition test, or drive better customer service
 - In a segment facing relatively high exposure, relative to the scale of the segment, the DNO may have an incentive to 'gold plate' its customer service, which could prevent competition developing
- An approach based on the market value represented by each segment would be much better:
 - This would mean the potential penalty Ofgem can impose in each of a DNOs market segments is proportionate to the value represented by that market – giving DNOs a stronger incentive to facilitate competition, or give good service, where more customer value is at stake
 - There should be no practical barriers to implementation, as connections reporting regimes mean we should have the necessary data, and only need to agree on a consistent and pragmatic methodology