



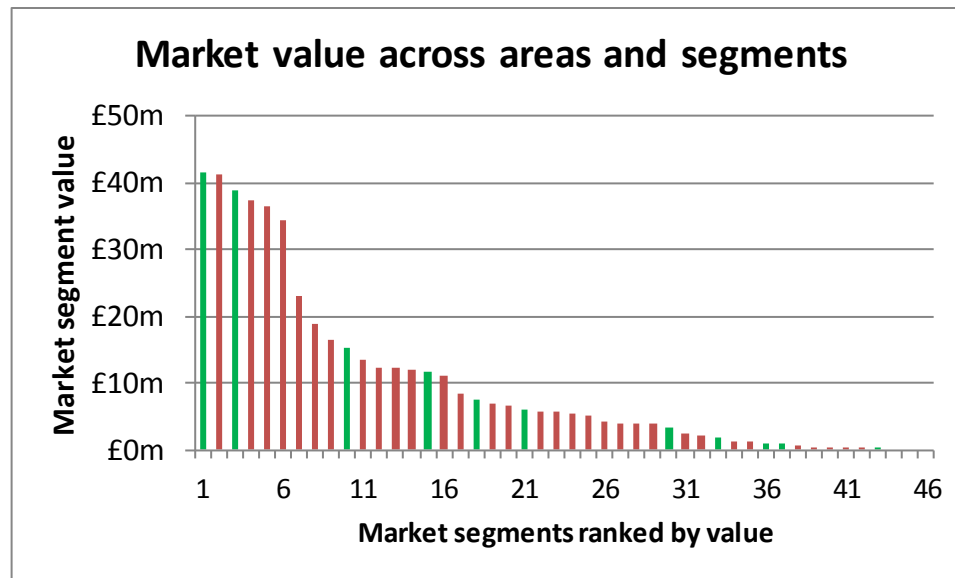
Using a value based split for the ICE penalty

Discussion pack

5 June 2013

Northern Powergrid favours a value based splits for the ICE penalty

- There are simple reasons for this:
 - The largest market segments by value are likely to be the ones where competition can bring the biggest benefits, so the incentives to pass (and keep passing) the competition test should be strongest
 - If competition may never develop, it makes sense for penalties to be proportionate to the value at stake
- The chart below shows that the largest segments have about 200 times the value of the smallest, so this is not a small differential we are talking about



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

But if value based splits are to be used, there needs to be a practical way of implementing them

- 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, in any given year
 - 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
- But there are at least two reasons to look at the practicalities for the licence of market value based splits:
 - It may make practical sense for there to be a minimum potential penalty in each segment, so that potential penalties never fall below a threshold like £100,000
 - There may also be advantages for DNOs from potential penalties being known in advance of the year, to focus management attention and for accounting purposes
- The rest of this pack sets out how three different approaches for implementing a value based split could be accommodated in the RII0-ED1 licence
 - An annually updated split, supported by appropriate reporting of market segment values, subject to a £100,000 minimum for each market segment
 - An annually updated split, but lagged by a year, so penalties are known in advance
 - A fixed split based on the latest data for market value before the ED1 period starts, subject to a periodic update wherever Ofgem or the licensee believes that significant changes in relative market value have taken place
- This pack does not set out a complete licence condition, and focuses instead on 3 alternative drafts for a section of the condition that would be needed to give effect to a market share based split of the penalty

The licence drafting to accommodate real time, annual, value based splits would not be challenging

1.1 For the purposes of the above formula, the maximum potential penalty for any given market segment in any given year (MPP_{it}) shall be calculated from one of the following formulas

(a) For all market segments where:
$$\left[\frac{MV_{it}}{\sum_{\forall i} MV_{it}} \right] \times TPP < \text{MinPP}$$

The maximum potential penalty MPP_{it} will be set equal to MinPP, and for the purposes of clause (b) below such segments will be denoted with subscript $i = n$, and numbered 1,2,...,s

(b) For all market segments where:
$$\left[\frac{MV_{it}}{\sum_{\forall i} MV_{it}} \right] \times TPP \geq \text{MinPP}$$

The maximum potential penalty MPP_{it} will be set equal to:
$$\left[\frac{MV_{it}}{\sum_{\forall i \neq n} MV_{it}} \right] \times [TPP - (s \times \text{MinPP})]$$

Where:

MV_{it} Is the value of work undertaken in segment i , in year t , as reported under the relevant RIGS

TPP Is the total potential penalty and has a value set out in Appendix 1

MinPP Is the minimum potential penalty and has a value set out in Appendix 2

Note: uprating for inflation has been abstracted from for simplicity

Other parts of the licence condition would ensure that penalties can only be applied to market segments that have not yet passed the competition and legal test

A small tweak to the same drafting would give companies advance notice of the potential penalty in each segment

1.1 For the purposes of the above formula, the maximum potential penalty for any given market segment in any given year (MPP_{it}) shall be calculated from one of the following formulas

(a) For all market segments where:
$$\left[\frac{MV_{it-1}}{\sum_{\forall i} MV_{it-1}} \right] \times TPP < \text{MinPP}$$

The maximum potential penalty MPP_{it} will be set equal to MinPP, and for the purposes of clause (b) below such segments will be denoted with subscript $i = n$, and numbered 1,2,...,s

(b) For all market segments where:
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While a different approach could proxy value based splits in an even simpler way, by setting a split and revisiting it when needed

1.1 For the purposes of the above formula, the maximum potential penalty for any given market segment in any given year (MPP_{it}) shall be as set out in the table in Appendix 1.

1.2 The Authority may, at the licensee's request, or with the licensees consent (which must not be unreasonably withheld), direct that the values set out in Appendix 1 to which paragraph 1.1 refers be replaced with alternative values set out in its direction, provided that the following conditions have been met.

1.3 The conditions referred to in paragraph 1.3 are that the Authority must:

- (a) have due regard to the purposes of this condition;
- (b) be satisfied, following consultation with the licensee, that the relative values of work undertaken in the connections market segments have changed, to the extent that an alternative split of TPP would be warranted;
- (c) specify a date from which the direction is effective, not being earlier than 1 April in the following regulatory year; and
- (d) ensure that

$$\sum_{\forall i} MPP_{it} = TPP$$

Note: uprating for inflation has been abstracted from for simplicity

Other parts of the licence condition would ensure that penalties can only be applied to market segments that have not yet passed the competition and legal test

Conclusions

- It would not be difficult to draft a licence condition that splits the total potential penalty under the ICE based on the market value in any given year
- Other ways of implementing a market value based split would also not be difficult in terms of licence drafting
 - A lag could be introduced to avoid any accounting headaches, but would lack some of the advantages of a real time split
 - The approach could be simplified even further, by setting a split based on the current market values, and revisiting it as and when relative market values change significantly
- Any of these approaches should represent a significant improvement on the targeting of an equal 9 way split of the potential penalty
- They all depend on collecting data on the estimated value of work in the market segments, to varying degrees
- Given several DNOs have already published such market value estimates in their competition notices, it should be possible to develop such a methodology – but this is where the bulk of the work would lie (not in licence drafting)