

Electricity distribution price control 2005-2010 Initial proposals

What is different about this price control?

There have been some important changes in the background against which the 2005-2010 distribution price control review is being carried out, and there are some significant new challenges:

- general recognition that **investment** to replace network assets and to improve network performance needs to increase
- there is now a greater focus on **quality of service**
- a need to respond to the growth in **renewables**. This will require investment in the distribution networks and changes to the regulatory regime.

What are the main proposals?

Incentives for investment

Some companies have forecast very significant increases in investment, others less so. Ofgem's job has been to challenge companies' plans so that investment is made efficiently, and where it is needed.

Investment is expected to rise by an average of around 30 per cent from current levels.

Where company forecasts have been fully justified they have largely been accepted. Where companies have not justified their forecasts adjustments have been made.

Ofgem is consulting on a new 'sliding scale' approach to setting capital expenditure (capex) allowances and incentives. This is intended to:

- retain an incentive for efficiency throughout
- reduce the emphasis on Ofgem's or its consultant's view of the appropriate level of capex
- reduce the perceived risk that the price control causes under-investment

Timetable

Date	Milestone
June 2004	Initial Proposals
September 2004	Update Paper
November 2004	Final Proposals
December 2004	Companies indicate willingness to accept new controls
April 2005	New price controls implemented

- allow but not encourage overspend, (expenditure in excess of the "allowance")
- reduce the possibility of "high" capex companies making very high returns from underspend
- reward the "low" capex companies if they deliver what they say, and
- avoid strong incentives to underspend by cutting corners and not delivering outputs or by storing up problems for subsequent periods.

Operating expenditure (Opex)

Companies have achieved significant operating efficiencies over the last ten years, but further efficiencies can still be gained.

Proposals seek a 10 per cent cut on average. The targets are stretching but realistic

Capex and opex allowances are summarised in the table below

DNO	Capital expenditure		Operating costs
	Company's proposed increase over actual spend	Increase from actual spend to Ofgem's proposed allowance	Proposed allowance compared to actual 2003/03 expenditure
CN - Midlands	46%	43%	-14%
CN - East Midlands	49%	47%	-2%
United Utilities	32%	34%	-19%
CE - NEDL	4%	9%	5%
CE - YEDL	23%	21%	-1%
WPD - South West	3%	6%	-11%
WPD - South Wales	-14%	-14%	4%
EDF - LPN	90%	56%	-28%
EDF - SPN	66%	61%	-29%
EDF - EPN	79%	42%	-10%
SP Distribution	34%	25%	-10%
SP Manweb	63%	38%	-17%
SSE - Hydro	21%	14%	8%
SSE - Southern	30%	36%	13%
Total	42%	33%	-10%

Notes: (1) for capex, comparisons are on five year totals and actual means 2000-2003 out-turn figures and company projections for 2003-2005.

(2) for opex, comparisons are average 2005-2010 to actual 2002/03

(3) In all cases, costs are adjusted/normalised to be as comparable as possible

Quality of service

The existing quality of service incentive scheme has provided real benefits to consumers, with an average reduction of 7 per cent in the number of customer minutes lost over the last 5 years. However, there is scope to tighten targets without putting excessive cost on consumers.

Ofgem is proposing to:

- reward the company that is currently the best performer
- strengthen the incentives that companies have to meet, or exceed, their service quality targets in the future
- strengthen incentives to help ensure that the quality of telephone response provided to consumers when they contact companies remains of a high standard

- streamline the compensation arrangements for consumers following severe weather events
- strengthen the incentives that companies have to restore supply following severe weather events.

Renewables

To respond to the renewable energy challenge, Ofgem has proposed:

- revised connection charging arrangements for connecting to the distribution network
- incentives on DNOs to respond proactively to requests from generators to connect to their network.

What are the implications for distribution charges?

Distribution charges account for **around 30 per cent** of the domestic consumer's bill.

Ofgem's initial proposals suggest that for most companies further reductions in distribution charges can be achieved

alongside improvements in service that are required. For others, it will be necessary for distribution charges to increase.

The following table outlines the breakdown of the change in distribution charges in the first year of the new control.

Distribution Network Operator	P0 change in 2005/06 (per cent)
CN - Midlands	- 6
CN - East Midlands	- 11
United Utilities	- 2
CE - NEDL	- 12
CE - YEDL	- 15
WPD - South West	0
WPD - South Wales	2
EDF - LPN	- 2
EDF - SPN	- 4
EDF - EPN	- 5
SP Distribution	8
SP Manweb	4
SSE - Hydro	0
SSE - Southern	6
Average P0 change	- 2

The changes in distribution charges reflect a number of factors, such as efficiency gains achieved in the current price control period, future efficiency targets and a number of

other costs such as tax, business rates and pensions. They do not in themselves give an indication of the efficiency of companies or likely future returns.

How do the previous price controls compare?

Year	P0 Cut (reduction in distribution charges in first year of the price control)	Xfactor (reduction in distribution charges in years 2 - 5)
1995-99	25.5%	3%
2000-05	24.5%	3%
2005-10	2%	1%

What is the electricity distribution network?

There are 14 Distribution Network Operators (DNOs) who, under licence, own, manage and operate the low voltage electricity wires (distribution network) throughout England, Scotland and Wales. Their primary function is to distribute electricity from the high voltage national grid into consumers' homes and business premises.

Distribution businesses are natural monopolies and are therefore subject to price control regulation to protect consumers' interests.

What is the price control designed to do?

- Ensure that the distribution companies do not abuse their position by charging too high prices and/or provide too low quality of service resulting in poor value for money for consumers.

Price control regulation provides incentives so the distribution companies can:

- invest in their networks in a timely and efficient manner
- offer good quality of service to customers
- manage and operate their networks in an economic, efficient and co-ordinated manner.

How does the price control work?

The amount of money that a monopoly business can earn on its regulated business is restricted by an RPI-X price control that is reviewed every five years. It controls prices, not profits, and encourages efficiency within the company.

The RPI-X price control takes the Retail Price Index (the rate of inflation) as its benchmark and constrains distribution charges to RPI plus or minus an X factor.

Map of UK distribution boundaries



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