# Electricity distribution price control 2005-2010

## What is different about this price control?

The background against which the 2005-2010 distribution price control review has been carried out included some significant new challenges:

- general recognition that investment to replace network assets and to improve network performance needs to increase
- 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.

**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 |

## What are Ofgem’s final 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.

In total the proposals allow for investment of **£5.7 billion** over the next price control, an increase of around **48 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 has used an innovative 'sliding scale' approach to setting capital expenditure (capex) allowances and incentives. This rewards companies that have best justified their capex projections. It provides flexibility for companies that need to spend more than Ofgem's analysis supports, but reduces the profits they can make by underspending their allowances.

Consumers pay for capex over long periods of time, generally over twenty years. Opex efficiency savings made in the current price control will now feed through to consumers and help offset the impact of capex increases on customers’ bills.

**Operating expenditure (Opex)**

Companies have achieved significant efficiency savings over the period of the existing price control. The benefits of these savings will be shared with consumers over the next price control period.

Further efficiencies can still be gained, but not on the same scale. Proposals seek a **3 per cent** cut on average.

Capex and opex allowances are summarised in the table below

| CAPEX | Company's proposed increase over actual spend | Increase from actual spend to Ofgem's proposed allowance (June 04) | Increase from actual spend to Ofgem's proposed allowance (Nov 04) |
|---|---|---|---|
| CN - Midlands | 44% | 41% | 49% |
| CN - East Midlands | 60% | 49% | 61% |
| United Utilities | 32% | 33% | 34% |
| CE - NEDL | 18% | 17% | 22% |
| CE - YEDL | 48% | 36% | 53% |
| WPD - South West | 22% | 19% | 28% |
| WPD - South Wales | -11% | -11% | -6% |
| EDF - LPN | 106% | 69% | 74% |
| EDF - SPN | 69% | 66% | 72% |
| EDF - EPN | 70% | 54% | 59% |
| SP Distribution | 48% | 46% | 43% |
| SP Manweb | 90% | 64% | 68% |
| SSE - Hydro | 26% | 17% | 23% |
| SSE - Southern | 36% | 39% | 50% |
| **Total** | **49%** | **41%** | **48%** |

| Opex | Proposed allowance compared to actual 2002/03 expenditure (June 04) | Proposed allowance compared to actual 2002/03 expenditure (Nov 04) |
|---|---|---|
| CN - Midlands | -14% | -5% |
| CN - East Midlands | -2% | 7% |
| United Utilities | -19% | -13% |
| CE - NEDL | 5% | 12% |
| CE - YEDL | -1% | -1% |
| WPD - South West | -11% | -9% |
| WPD - South Wales | 4% | 10% |
| EDF - LPN | -28% | -12% |
| EDF - SPN | -29% | -22% |
| EDF - EPN | -10% | -3% |
| SP Distribution | -10% | -3% |
| SP Manweb | -17% | -10% |
| SSE - Hydro | 8% | 15% |
| SSE - Southern | 13% | 18% |
| **Total** | **-10%** | **-3%** |

## Cost of capital

Ofgem has set the 'cost of capital', the level of return a company can make on their investment, at **4.8 per cent (post-tax)**. This will provide distribution companies with sufficient incentive to undertake the challenging programme of investment during the next price control period.

## How do the previous price controls compare?

| Year | **Cost of capital** (pre-tax) |
|---|---|
| 1995-99 | 7% |
| 2000-05 | 6.5% |
| 2005-10 | 6.9% |

## 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 2 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
- £0.5 billion package of incentives for Distribution Network Operators (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 25 per cent of the domestic consumer's bill.

On average across, Great Britain, distribution charges will increase in the first year of the price control by **around 1 per cent** on average. This equates to around **6 pence per month** on the average customers bill. Thereafter distribution charges will increase in line with inflation **(RPI-0)**.

Ofgem's final proposals suggest that for some 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.**

**Final proposals for PO (Year one changes to distribution charges)**

| DNOs | June Initial Proposals % | Change % | September Update % | Change % | November Final Proposals % |
|---|---|---|---|---|---|
| CN - Midlands | -6.5% | 2.0% | -4.5% | 1.6% | -2.9% |
| CN - East Midlands | -10.8% | 3.3% | -7.5% | 1.8% | -5.7% |
| United Utilities | -1.8% | 7.4% | 5.6% | 2.4% | 8.0% |
| CE - NEDL | -11.5% | 8.6% | -2.9% | -0.8% | -3.7% |
| CE - YEDL | -14.7% | 1.8% | -12.9% | 3.7% | -9.2% |
| WPD - South West | -0.2% | 1.8% | 1.6% | -0.1% | 1.5% |
| WPD - South Wales | 1.7% | 5.6% | 7.3% | -1.1% | 6.2% |
| EDF - LPN | -2.5% | -1.7% | -4.2% | 1.8% | -2.4% |
| EDF - SPN | -3.7% | 6.7% | 3.0% | 4.2% | 7.2% |
| EDF - EPN | -4.6% | 2.5% | -2.1% | 2.0% | -0.1% |
| SP Distribution | 8.4% | 2.2% | 10.6% | 1.3% | 11.9% |
| SP Manweb | 4.0% | -9.5% | -5.5% | -0.4% | -5.9% |
| SSE - Hydro | -0.1% | 2.8% | 2.7% | 1.2% | 3.9% |
| SSE - Southern | 6.1% | 3.1% | 9.2% | 0.1% | 9.3% |
| **Average** | **-2.5%** | **2.5%** | **0.0%** | **1.3%** | **1.3%** |

Notes: (1) The above PO % include allowances for Innovation Funding Initiative (IFI)
(2) For comparability, EDF-SPN is shown on the basis of X=0. Actual PO will be 3.1%, with RPI+2

This table shows P0 adjustments on the basis of X=0. In the case of EDF-SPN, in order better to reflect the timing of revenue requirements, P0 will be set to be 3.1% and distribution charges will subsequently be restricted to RPI+2. The impact of this change on revenue and charges over the five year period is broadly neutral.

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 give an indication of the efficiency of companies or likely future returns.

## How do the previous price controls compare?

| Year | P0 (average changes to distribution charges in first year of price control) | Xfactor (reduction in distribution charges in years 2-5) |
|---|---|---|
| 1995-99 | -25.5% | 3% |
| 2000-05 | -24.5% | 3% |
| 2005-10 | +1.3% | 0% |

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