SP Transmission & Distribution

Response to Ofgem Consultation Papers:

Developing Network Monopoly Price Controls (Initial Conclusions June 2003)

Electricity Distribution Price Control Review (Initial Consultation July 2003)

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EXECUTIVE SUMMARY

The distribution price control review and the Scottish transmission price control review are different from previous price reviews. Increasing costs in a number of areas, including distributed generation and network investment, will result in an upward pressure on prices.

The key issues are as follows:

- a sufficient and stable return is required to attract and retain equity funding;
- a framework for the connection of renewable generation needs to be agreed and implemented if the Government targets are to be achieved;
- allowed investment must be increased to secure the long-term safety, reliability and sustainability of the electricity infrastructure; and
- a sound and transparent approach to efficiency analysis is required to ensure adequate funding.

These issues are addressed in more detail below.

COST OF CAPITAL

An increased cost of capital is strongly supported by market evidence, recent regulatory determinations and authoritative academic studies.

- A higher cost of capital will promote future investment confidence and incentives.
- A pre-tax approach to cost of capital must be retained in order to provide the correct incentive to maintain tax liabilities at an efficient level in the medium to long-term.

DISTRIBUTED GENERATION

Government targets for renewable energy are extremely challenging. The regulatory framework must support the achievement of these targets and avoid creating unnecessary risk and uncertainty for all stakeholders.

- A forward-looking investment framework will be the most economic and effective means of ensuring that additional network capacity is made available when and where it is needed most.
- The hybrid scheme suggested by Ofgem will only be appropriate if it does not expose companies to excessive risk.
- Appropriate allowance must be made for the additional operating costs arising from increased complexity of network operation and the costs associated with any network availability measures.

NETWORK INVESTMENT REQUIREMENTS

Allowed investment levels must be increased to secure the long-term safety, reliability and sustainability of the electricity infrastructure.

- A long-term investment programme, focussed on critical assets, needs to be agreed now.
- This programme must address each company's specific requirements.

ASSESSING COSTS AND EFFICIENCY

There must be recognition that lowest cost is not necessarily the most efficient or the most effective.

- Transparency is essential in order to enable companies to understand and examine Ofgem's analysis and conclusions.
- A sound approach, that does not rely on any single measure and takes proper account of regional and inherited factors, is required.
- Simplistic analysis of past cost-trends would result in serious misrepresentation of the future potential for cost-reductions.

In addition to the high level issues noted above, there are several important specific issues that require consideration. These are set out below.

- **Review of Scottish Transmission Price Controls**

  Further clarification is required on a number of important issues to enable proper consideration of any proposal for a roll-forward of the Scottish transmission price controls. These include:

  – arrangements for RETS funding; and
  – adjustments for the impact of BETTA.

- **Depreciation Cliff-Edge**

  The approach used by Ofgem to smooth the revenue profiles of those companies that faced this issue at the last review must be extended to all companies.

  – Revenue profiles should be smoothed by accelerating depreciation of post-vesting assets.
  – The alternative approach, of expensing a portion of capex, is not appropriate as it would introduce significant distortions to incentives due to the excessive proportion of capex that would have to be expensed.
  – Early clarity is required on Ofgem's proposed treatment of this important issue.

- **Pensions**

  Ofgem must take proper account of the reasons why deficits have arisen and must assess future costs in a fair, consistent and transparent manner.

  – Costs associated with liabilities under the Electricity Act 1989 must be fully funded within price controls.
  – The costs of providing enhanced benefits under severance arrangements are legitimate costs that have delivered price reductions to customers.

We are committed to working with Ofgem and the rest of the industry throughout the review process to deliver a successful outcome that balances the interests of customers, shareholders and all other stakeholders. We hope that our comments will prove helpful in meeting this objective.

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INTRODUCTION

1. This document is the response of SP Transmission & Distribution to the following Ofgem consultation documents:

   - Developing Network Monopoly Price Controls – Initial Conclusions (June 2003); and
   - Electricity Distribution Price Control Review – Initial Consultation (July 2003).

2. The response focuses on issues for the distribution price control review (DPCR) and the Scottish transmission price control review, however many of the principles are applicable to all network monopoly price controls. We have provided a combined response as both Ofgem consultation papers are closely related. The headings used in this response document are, as far as possible, consistent with the headings used in the Ofgem documents.

3. This document is split into two parts:

   - Part 1, providing our response to the DPCR paper. This also includes our response to the issues raised in the Network Monopoly Price Controls paper in the areas of efficiency incentives and financial issues; and
   - Part 2, providing our response to the issues raised by the Network Monopoly Price Controls paper (excluding efficiency incentives and financial issues).

PART 1: RESPONSE TO DPCR CONSULTATION PAPER OF JULY 2003

SECTION 1: FORM, STRUCTURE AND SCOPE OF THE PRICE CONTROL

1.1 STRUCTURE OF THE PRICE CONTROL

1.1.1 Subject to our comments on the various components, the broad structure of the price control remains appropriate.

1.2 REVENUE DRIVERS

1.2.1 The revenue driver should be 100% weighted to customer numbers as the volume of units distributed is not a significant cost driver and, therefore, is not an appropriate revenue driver. In addition, uncertainty is increasing around future levels of units distributed as a result of distributed generation, the increased focus on energy efficiency and stronger incentives to reduce losses. This uncertainty could result in undesirable revenue and price volatility if the volume of units distributed is retained as a revenue driver.

1.2.2 The basis for the projection of future customer numbers used in the revenue driver should be actual customer numbers as defined in the RIGs (Regulatory Instructions and Guidance), derived from MPANS (Meter Point Administration Numbers) and as reported for IIP (Information and Incentives Project). This will ensure the most accurate basis for the projection.

1.3 SCOPE OF PRICE CONTROLS

1.3.1 Subject to the following comments, there should be no change to the scope of the price controls.

Excluded Services

1.3.2 Connection charges to EHV customers are calculated on a site-specific basis and, as such, should continue to be excluded from the scope of the price control. If Ofgem's proposal to move to a 'shallower' regime for such charges is implemented, then any revenue associated with shared EHV assets must be recovered via the price control.

1.3.3 Pre-payment metering surcharges and special metering charges are covered in comments on the general treatment of metering in our response to Ofgem's July 2003 consultation paper on metering price controls.

Competition in Connections

1.3.4 A price control for non-contestable connection services would not be in the best interests of customers. Charges for these services are already effectively regulated through existing licence conditions and competition law and there is no evidence supporting a need for change. Under the existing arrangements, encompassing cost-reflective and transparent charging in line with the Licence Condition 4 Statement, charges are subject to challenge and subsequent determination by Ofgem.

1.3.5 The development of competition in connections, and the interests of customers in general, will be best served by continuation of the existing regulatory arrangements coupled with the introduction of appropriate performance standards. A price control for non-contestable services would be complex to design, would remove the cost-reflective element of charging and could, we believe, hinder rather than facilitate the development of competition in connections.

1.3.6 The significant regional variation in market penetration of competition, and the resultant variation in costs incurred to facilitate and support competition, must be considered when deriving an appropriate allowance for the provision of connection services. The use of a simple yardstick approach to efficiency benchmarking will not capture this adequately.

1.3.7 We are committed to the satisfactory introduction of competition in connections across the whole industry and therefore support the introduction of suitable performance measures and standards. The following principles are fundamental to the introduction of a satisfactory regime:

- standards must be clearly defined to enable accurate and consistent measurement and reporting;
- implementation costs (such as administration, IT systems etc.) must be fully funded;
- the number of standards must be proportional to those in place for other company activities, based on the value and relative importance of these other activities;
- targets should only be finalised when robust and auditable statistics are available to verify reported performance, when a decision can then be taken on whether to include payments; and
- it must be made clear to all parties that failure to meet service standards will not result in liability for consequential loss.

1.3.8 Appropriate performance standards, focussing on the critical parts of the business process are as follows:

- the time to provide a firm quotation;
- the time to approve the contestable works design; and
- the percentage of non-contestable work requests completed on the agreed date.

Wheeling Charges

1.3.9 Companies, such as SP Manweb, that incur 'wheeling' charges in respect of electricity transported across the network of another distribution company have no means of recovering these charges under current arrangements. This can result in distorted investment incentives by discouraging companies from making use of a neighbouring network even when this is the most efficient investment decision.

1.3.10 This significant anomaly can be resolved by means of a small change to the definition of 'distribution revenue' so that wheeling charges are treated as pass-through costs in a similar way to transmission exit charges. We urge Ofgem to make this change as soon as possible and to give proper consideration to allowing recovery of the costs incurred during the current price control period.

1.4 DURATION OF THE PRICE CONTROL

1.4.1 We note Ofgem's view that it is appropriate to retain a five-year period for the price control. However a period of greater than five years could be appropriate for the price control, or for elements of the price control (particularly for elements of network investment), if the issue of increasing uncertainty can be adequately addressed.

1.4.2 Transparent mechanisms for dealing with cost uncertainty between price reviews are required regardless of the duration of the price control. This will benefit all parties. Our comments on the framework for uncertainty outlined by Ofgem are included in Section 9 of this document.

1.5 FIXED RETENTION PERIOD FOR EFFICIENCY SAVINGS

Review of Efficiency Incentives

1.5.1 We welcome the review of efficiency incentives to remove existing distortions and ensure consistency with quality of service incentives and with incentives to maintain the longer-term performance and security of the network.

1.5.2 While we are pleased that timing distortions will be addressed by the introduction of rolling incentives, we have a number of significant concerns. These are as follows:

- there is no detail on the rolling mechanism;
- there is no mechanism to address incentive distortions between capital expenditure (capex) and operating expenditure (opex);
- there is a need to strengthen efficiency incentives.

1.5.3 We have developed detailed and practical proposals for a rolling regime that removes the distortions arising from timing and from differences between capex and opex incentives. A paper outlining these proposals was submitted to Ofgem in June 2003. We urge Ofgem to give full consideration to these proposals and to use them when developing the final approach.

1.5.4 In summary, the proposal is based on the Ofwat scheme and has the following main characteristics:

- timing distortions are eliminated by a rolling mechanism;
- distortions to capex/opex incentives are eliminated by the use of a 'regulatory reserve' to capture savings; and
- incentives are strengthened and distortions removed without any requirement to lengthen the period between price reviews.

Capex/Opex Distortions

1.5.5 Removal of the capex/opex distortions implicit within the current regime will ensure that companies are incentivised to make the most efficient decisions regardless of the expenditure category. This point is supported by the Frontier Economics' paper[1] of March 2003 prepared for Ofgem. While the use of a total cost approach might go some way towards mitigating the effect of these distortions it is no substitute for their removal.

1.5.6 Ofgem's June paper on Network Monopoly Price Controls correctly identifies four different types of efficiency each with different retention rates. There is no straightforward means of ensuring consistency of incentive rates across all four, however it is straightforward to ensure consistency between the most common i.e. permanent opex savings and one-off capex savings.

1.5.7 Consistency is achieved by de-coupling capex savings from the RAV and capturing them in a regulatory reserve. These savings would be returned to customers after a pre-specified period of time. Similarly, opex savings are captured in the regulatory reserve and returned over the same period of time. The amount of revenue in any year arising from retained efficiencies would be calculated on the basis of the retention rate and the retention period.

1.5.8 De-coupling capex savings from the RAV also enables different companies to retain the same share of capex savings regardless of regulatory depreciation lives. This enables the removal of another distortion implicit within the current regime, and under any rolling regime linked to the RAV, where companies with different assumptions on regulatory depreciation retain differing proportions of capex savings.

[1] Frontier Economics paper of March 2003 entitled "Developing Network Monopoly Price Controls: Workstream B – Balancing Incentives – A final report prepared for Ofgem"

Incentive Strength

1.5.9 Ofgem refers to reported out-performance of the current price controls and concludes that there is no strong evidence that incentives for efficiency need to be increased or weakened. However, it is more important to focus on the future scope for efficiencies, rather than on past performance, when considering incentive strength.

1.5.10 Incentives to achieve efficiency savings need to be strengthened to ensure that customers continue to benefit from efficiency gains. Future gains will require greater effort and innovation and many initiatives will require up-front expenditure to stimulate future cost savings.

1.5.11 Controllable costs now represent a far smaller proportion of total costs than at previous reviews. Analysis of the costs of our distribution businesses indicates that controllable opex costs, as a percentage of total opex costs, have reduced from a figure in excess of 60% in 1996 to less than 40% in 2003. In addition there are a number of factors that are causing cost increases, including distributed generation, pensions, security, insurance and streetworks.

1.5.12 A 50:50 sharing of efficiency savings between companies and customers is optimal. This will benefit customers as future efficiency savings will be passed back in subsequent price controls.

Retention Period

1.5.13 We note Ofgem's view that the retention period should be consistent with the price control period. However, linking the retention period too closely to the price control period will unduly restrict the way in which incentives for efficiency savings are set. The focus should be on establishing a more appropriate sharing of efficiency savings, rather than tying the retention period to that of the price control.

1.5.14 Opex savings made in 2002/03 must be included in the rolling mechanism. Ofgem's proposal to apply the rolling mechanism for savings made from 1 April 2003 will result in companies retaining a smaller proportion of savings made in 2002/03 than in the preceding year and in all subsequent years.

1.6 IMPROVING THE INCENTIVE AND PRICE CONTROL FRAMEWORK

1.6.1 We welcome Ofgem's efforts to improve the overall incentive and price control framework. An inappropriate framework will distort behaviour and negatively impact customers' interests.

Improvements to the Incentive Framework

1.6.2 The focus of improvements to the incentive framework must be on refining the operation of IIP (as applied to the existing output measures) rather than significantly extending the range of output measures. In particular, it is important to address the following problems associated with the current IIP incentive scheme:

- the potential exposure of companies to events outside their control. (e.g. weather);
- the degree of subjectivity in adjusting reported performance;
- the variation in the degree of difficulty of system performance targets across the industry;
- the short-term nature of the existing targets;
- the lack of clarity in how the incentive mechanisms will be rolled forward; and
- the variation of incentive rates across companies and whether they appropriately reflect customers' willingness to pay.

Rewarding Frontier Performance

1.6.3 We welcome Ofgem's recognition that IIP targets for some companies are more onerous than for others. Frontier performing companies should be rewarded for their improvement above their starting levels, at the current incentive rate, whether or not they have fully achieved their 2004/05 targets.

1.6.4 Where there is a wide variation between the best and worst performers then the frontier companies should be rewarded by less onerous performance improvement targets during the next price control period, even to the point of no improvement target. Where there is a small variation between the best and worst performer then it is inappropriate for Ofgem to provide any additional 'reward' to the frontier performer.

SECTION 2: QUALITY OF SERVICE AND OTHER OUTPUTS

2.1 KEY ISSUES FOR REVIEWING THE OUTPUT FRAMEWORK

2.1.1 There are a number of fundamental principles that must be applied when considering appropriate outputs. These are as follows:

- incentives should only be based on aspects of performance that have been proven to be measured to a high degree of accuracy and are under management control within the period of the price control;
- new measures should be introduced firstly as 'reportable statistics' and only become subject to an incentive once the level of reporting accuracy and consistency has been established by means of an audit;
- incentives should relate to 'high level' aspects of performance that have been established to be important to customers;
- a focused approach should be taken, each area of the business should be covered by a small number of key measures (say no more than three); and
- each incentive should be subject to appropriate ‘floors’ and ‘ceilings’.

Scope of the Output Measures

2.1.2 We agree that the scope of output measures should be based on measures required to protect customers’ interests, informed by robust research into customers’ priorities and willingness to pay.

2.1.3 We are committed to our social and environmental responsibilities but do not support an extension to the scope of output measures to include performance in these areas. Performance in these areas is already reported and is monitored by a number of other regulatory bodies. The introduction of additional output measures in these areas would be duplication of effort and could result in companies being exposed to multiple penalties for the same event.

2.1.4 We note Ofgem's consideration of whether there should be additional outputs and incentives regarding the resilience of companies' networks and the effectiveness in restoring supplies following exceptional events. Ofgem should introduce a separate mechanism to incentivise companies to perform well following storm conditions. The costs of achieving any expected improvement in performance under such an incentive regime should be treated on a company specific basis, and would require full funding through an appropriate allowance.

2.1.5 The absolute number of exceptional events, and any trends in their occurrence, would require to be reviewed against customer expectations and anticipated weather patterns to establish the investment programmes required to influence the frequency of occurrence of future events. However, substantial re-design and replacement of overhead networks would be required to significantly reduce the frequency and impact of the most severe events. This is unlikely to be economic.

Form of the Incentive Scheme, Targets and Incentive Rates

2.1.6 Targets for output measures should focus on the long-term, especially where improvements are required to implement fundamental changes to networks. Such an approach would help to reassure customers that companies are maintaining the network to secure its longer-term integrity.

2.1.7 It is inappropriate to require increased performance levels that go beyond the expenditure assumptions underlying the price review. Future expenditure assumptions, at subsequent price reviews, must not be curtailed in a way that could risk the delivery of desired performance levels.

2.1.8 We note that Ofgem are considering the treatment of planned interruptions under IIP. Such interruptions should be excluded from IIP to remove the perverse incentive to delay or curtail network investment because of the impact on IIP performance.

Development of Guaranteed and Overall Standards of Performance (GOSPs)

2.1.9 There is merit in the inclusion of performance against Overall Standards (OS) in an incentive regime. The following issues must be addressed in order for this to be acceptable:

- the specified levels of performance must be reviewed to set challenging yet achievable targets;
- the overlap with current IIP output measures is removed;
- the inconsistencies between the level of network performance required and licence design standards are eliminated; and
- the potential financial penalty under the Electricity Act 1989 (as amended) for failure to meet specified levels of performance is withdrawn.

2.1.10 Guaranteed Standards (GS) should not be subject to any overall incentive mechanism but should continue to relate to the level of service provided to individual customers. Normal commercial arrangements link compensation for the loss of any service to the amount paid for that service, unless specific provision is made for consequential loss. As use of system terms do not provide for consequential loss, annual compensation payments to any customer must be capped at the level of the annual use of system payment made by that customer.

2.1.11 The cost of implementing systems and procedures to support the introduction of automatic payments under GS 2 (restoration within 18 hours) will be prohibitive for the foreseeable future. This is due to the difficulty and excessive cost of identifying, recording and updating the phase to which single phase customers' premises are connected.

Consumer Research

2.1.12 Ofgem's efforts to consider customers' preferences in developing the incentive and price control framework at this review are welcome. However, we are concerned that phase one of Ofgem's research is narrowly focused and will not establish an accurate range of criteria that customers and society value. Careful consideration must be given to the design of phase two of this research to ensure that robust results are obtained. In particular, there should be a greater focus on establishing willingness to pay for improvements in quality of service and supply. Any consideration of customer willingness to pay must take into account all appropriate Government and regulatory guidelines.

2.1.13 In fulfilling its duty to customers both current and future, Ofgem must recognise that the aggregated preferences of individual customers might not reflect the appropriate overall decision. For instance, investment in long-term security and improvement of the network will be in the interests of all customers and will be required regardless of whether surveys indicate that current customers are willing to pay for such investment.

2.1.14 We are pleased to have had the opportunity to work with Ofgem and the rest of the industry on Ofgem's Willingness to Pay working group. We remain committed to this working group and believe that it has a significant role to play in assessing and understanding customers' preferences and willingness to pay.

Comparing Quality of Supply Performance

2.1.15 The disaggregation process being developed by Ofgem will be useful in revealing the reasons behind performance variance between companies and highlighting those aspects of performance that each company should review. Disaggregated performance should be a key aspect of the Forecast Business Plan Questionnaire (BPQ). Companies should be required to analyse their performance in each disaggregated category, identifying the good and poor

aspects of performance, and to explain either why performance improvement is inappropriate, or to propose investment plans supported by costs and anticipated improvements.

2.1.16 It is important to avoid simplistic analysis of disaggregated data to inform inter-company comparison at an aggregated level (i.e. overall network performance). Proper account must be taken of possible interactions between different factors and due consideration given to reasons for differing performance.

2.2 REWARDING FRONTIER PERFORMANCE

2.2.1 Our comments on this issue are set out in paragraphs 1.6.3 and 1.6.4.

2.3 TREATMENT OF EXCEPTIONAL EVENTS

2.3.1 We share Ofgem's concerns and objectives in this area and note the comment that the process can be resource intensive for both Ofgem and Energywatch. The current process is also extremely resource intensive for companies and it is in the interests of all parties that this issue is resolved satisfactorily. We are committed to continuing to work with all parties to ensure satisfactory resolution.

2.3.2 The criteria for excluding exceptional events from both incentive and GS payments needs to be fully defined as part of the price review proposals so that companies understand the level of risk that they face. The current exceptional event exclusion arrangements for IIP have taken over 18 months to develop. These arrangements must be refined (rather than replaced) to address aspects such as company mutual support arrangements and must remain in place for the next price control period.

Exemptions from GS Payments

2.3.3 Ofgem's suggested interim solution for dealing with exemptions to GS payments is not acceptable. It is not reasonable to require companies to make payments on all claims and then engage in a protracted process to secure recovery during the next price control.

2.3.4 Companies should remain exempt from the obligation to make GS payments during periods when they face exceptional levels of damage to their networks. In such circumstances customers will often face interruption times that relate to fault repair times.

2.3.5 It is not appropriate for Ofgem to apply a crude benchmark to determine whether or not an event should qualify for exemption. Such an approach represents a gross simplification that cannot give proper consideration to the unique circumstances of a specific event. If there is a concern that a particular company has not responded to an event in an appropriate manner, then a detailed investigation of the specific circumstances must be carried out.

2.3.6 In principle, it is possible to remove exemptions if companies are given appropriate funding to meet the costs of the associated compensation payments or to cover the appropriate insurance premiums. Companies will also require appropriate funding to undertake the necessary investment programmes to reduce exposure over time. Removing exemptions is unlikely to avoid a large volume of customer disputes, as many relate to the perceived duration of the interruption and claims for consequential loss.

2.3.7 It is unclear whether insurance, conventional or otherwise, presents a viable solution for the treatment of exceptional events. Companies' ability to insure against the impact of exceptional events has been severely reduced as a result of the changes in worldwide insurance markets since 2000. In the particular case of overhead assets, it is now almost impossible to arrange any form of conventional insurance and for other asset types the cost of even limited

cover has increased significantly. Furthermore, it has to be clarified whether GS payments are categorised as 'statutory payments' and, as such, would be uninsurable. We are keen to work with Ofgem and the industry to address this issue and determine whether insurance could present a viable solution.

2.4 INCENTIVES FOR SPEED AND QUALITY OF TELEPHONE RESPONSE

2.4.1 Our comments on incentives for speed and quality of telephone response are included in our response to Ofgem's consultation of July 2003 on this matter.

SECTION 3: DISTRIBUTED GENERATION

3.1 FACILITATING DISTRIBUTED GENERATION

3.1.1 We agree with Ofgem that any mechanism to facilitate distributed generation (DG) must balance the need to minimise the financial risk on companies against the need to protect customers' interests in terms of the costs that they will bear. Government targets for renewable energy are extremely challenging. The regulatory framework must support the achievement of these targets and avoid creating of unnecessary risk and uncertainty for all stakeholders.

3.2 INCENTIVES FOR NETWORK ACCESS AND INVESTMENT

3.2.1 Any mechanism that places excessive risk on companies will act as a barrier rather than an incentive for DG investment. Incentives for DG and innovation should therefore only apply to those aspects that can be controlled by companies and only proportionately to the degree of that control.

3.2.2 Companies cannot control the location and volume of distributed generation that is connected to their networks. However, in order to facilitate the connection of distributed generation, companies can work towards:

- reducing costs of connections in areas where a significant number of generators are interested in connecting; and
- ensuring that networks are made available as close as possible to the time when required by generators.

3.2.3 We are pleased that Ofgem accepts the principle that advance investment can be the most efficient and effective means of facilitating DG. For those companies that are already significantly impacted by DG, in terms of interest and formal applications, it will be possible for a baseline programme of

investment to be agreed with Ofgem. Such investment, which would be based on a reasonable assessment of demonstrable need, would be secured in the RAV with only the efficiency of implementing the agreed schemes being assessed after the event.

3.2.4 Significant changes to such a programme would be dealt with as an interim adjustment to the price control. Minor changes would be dealt with by a suitable adjustment mechanism (such as Ofgem's suggested hybrid mechanism) or by logging up for recovery via the next price control. Such a regime would offer an appropriate balance between exposing companies to excess risk and protecting customers from inefficient expenditure.

Hybrid Scheme

3.2.5 We agree in principle that a hybrid scheme could be an appropriate means of dealing with investment that is incremental to the agreed programme depending on the balance between the two components. In order to be effective the hybrid scheme must not expose companies to excessive risk.

3.3 NETWORK AVAILABILITY

3.3.1 Rather than introducing new measures and incentives for network availability, existing measures under IIP and GS/OS should be refined to ensure consistency of treatment between generation and demand. The incentive regime must relate to the charges paid by the generator rather than the potential cost to the generator of the network being unavailable.

3.3.2 If companies are to make use of services that can be offered by generators it is essential that existing distortions are adequately addressed. At present companies are faced with deferring or avoiding network reinforcement (providing a benefit for up to five years) and incurring ongoing operating costs and liabilities in terms of payments to generators. Such costs need to be

adequately funded and must be ring-fenced to avoid having a detrimental impact on performance in comparative efficiency assessments.

3.4 INNOVATION AND REGISTERED POWERED ZONES

3.4.1 Our comments on the issues of innovation and registered power zones are included in our response to Ofgem's July 2003 discussion paper on this issue.

3.5 GB COST-RECOVERY

3.5.1 A significant proportion of the distributed generation required to meet Government targets will locate in the licensed areas of a few companies. It is therefore desirable that a scheme be introduced to ensure that the price increases required to fund the costs of meeting Government targets are spread across all customers in Great Britain.

SECTION 4: ASSESSING COSTS

4.1 ASSESSING COSTS AND EFFICIENCY

4.1.1 We welcome Ofgem's intention to utilise several alternative approaches to assessing costs and efficiency. Such assessments are complex and reliance on only one or two approaches would result in biased conclusions, and could significantly compromise companies' ability to finance their functions.

4.1.2 Transparency, in terms of approach and analysis, is essential. Companies must have access to the analysis carried out by Ofgem and be able to understand and examine the conclusions reached.

4.1.3 It must be recognised that past performance is not necessarily a good indicator of future performance when assessing future costs. The industry has achieved significant cost reductions over previous price control periods and the ability to achieve future costs savings is limited. Controllable costs now represent a far smaller proportion of total costs than at previous reviews (see paragraph 1.5.11).

4.1.4 The interpretation of analysis of past cost trends requires careful consideration. Simplistic analysis of past cost trends and movements, without a thorough examination of the reasons for the observed performance, is likely to result in serious misrepresentation of the future potential for cost reductions.

The Use of Bottom-Up and Top-Down Modelling

4.1.5 The use of comparative analysis of activity costs within companies and the use of 'best in class' costs across all activities can lead to an unattainable cost base. This must be avoided by assessing relative efficiency at an aggregated level, taking proper account of company specific factors and differences in important areas such as:

- engineering policies (including Asset Risk Management policies) and construction standards;
- levels of activity in particular areas and the resultant impact on unit costs; and
- cost allocation methodologies.

4.1.6 It is important that a number of approaches are used for top-down modelling. The strict use of frontier benchmarks would result in an over estimation of the potential for cost reductions because of data consistency problems and comparability issues between companies. There are several alternatives for taking this 'statistical noise' into account. One potential approach is to use average benchmarks. However, any estimate of relative efficiency will contain significant statistical noise and the weighting given by Ofgem to such estimates must take account of this.

4.1.7 A significant amount of Ofgem's effort is devoted to the determination of an 'efficient level of costs'. Proportionate effort should be allocated to the determination of glide paths for future cost bases because of the reduced scope for further efficiency savings and the need to continue to provide strong incentives to achieve such savings.

4.2 APPROACH TAKEN DURING DPCR3

4.2.1 It is important that lessons from previous reviews are learned and implemented. In this context we welcome Ofgem's consideration of potential improvements to the approach taken at the last review and our comments are provided with this in mind. More detailed comments and suggestions for improvements on the approach adopted during the last review are provided in Appendix 1 of this document. In summary our comments are as follows:

- Ofgem's efficiency analysis, including the normalisation adjustments and the regression analysis contained significant flaws;
- PKF's bottom up analysis, on which Ofgem placed considerable weight, contained a number of fundamental flaws including lack of transparency, arbitrary adjustments, simplistic ratio analysis and a 'cherry picking' approach to benchmarking; and
- too much emphasis was placed on historic expenditure and allowances when assessing future capital expenditure requirements.

4.2.2 We are pleased that Ofgem has appointed consultants to assess the approach taken to regression analysis at the last review and to provide advice on improvements and alternative techniques. The results of this work should be published to ensure transparency.

4.3 THE USE OF ASSET RISK MANAGEMENT SURVEYS AND ASSESSMENT OF FUTURE LEVELS OF INVESTMENT

4.3.1 We welcome Ofgem's intention to gain a better understanding of companies' approach to planning network expenditure based on asset condition. Companies continue to develop more advanced Asset Risk Management (ARM) and asset replacement regimes resulting in an improved focus and re-prioritisation of investment. Ofgem must use its assessment of ARM policies and practices of each company as a major determinant in establishing the credibility of investment plans.

4.3.2 Historically, regulatory approaches to capital expenditure have tended to be backward looking, focusing on past expenditure and allowances. Future allowances must address the future needs of the network. An assumption that historic expenditure levels are adequate simply because performance has not deteriorated ignores the time delay between increasing network risk and any observable deterioration in performance.

4.3.3 The severity of weather conditions faced by different companies is a fundamental factor that must be properly considered. Recent experiences with storms have highlighted the variable weather patterns across GB. Evidence clearly indicates that some companies are exposed to more severe weather conditions and will require to increase investment in storm resilience initiatives.

4.3.4 It is important to recognise that investment needs and priorities change over time. It is apparent from Ofgem's recent ARM survey that companies are at different stages of development and it is reasonable to assume that investment plans and priorities will change as companies converge toward best practice.

Increased Investment

4.3.5 The level of investment in infrastructure in general has been of considerable interest recently. As far as the electricity infrastructure is concerned, allowed investment needs to be increased to secure its long-term safety and integrity.

4.3.6 A prioritised programme of investment, focussed on critical assets, is required. This programme will span at least the next two price control periods and will require commitment and support from Ofgem. The main drivers of this requirement for increased investment are as follows:

- maintaining current levels of integrity and performance;
- improving network performance for worst served customers and increasing the storm resilience of networks;
- meeting the requirements of the Electricity Supply Quality and Continuity (ESQC) Regulations; and
- accommodating distributed generation.

4.3.7 It must be recognised that each company will have specific investment requirements. These requirements will be driven by its own regional priorities, asset base (including age profile, mix, design, construction standards, condition and performance) and customer requirements. In addition, it must be recognised that companies are at different positions on the investment cycle.

4.4 TOTAL FACTOR PRODUCTIVITY

4.4.1 The results of any Total Factor Productivity (TFP) analysis will require careful interpretation. There is considerable doubt as to whether TFP analysis can provide sufficiently robust assessments for use in setting allowances. TFP assessments require numerous assumptions in order to derive appropriate cost benchmarks, and these derived benchmarks are sensitive to the assumptions used.

4.4.2 TFP does not take account of several important factors, such as output quality, exogenous factors and relative efficiency, which are all key determinants of cost performance over time. In addition, as previously stated, past performance trends are not necessarily a good indicator of future performance trends.

4.5 HOW COMPANIES' OWN COST PROJECTIONS SHOULD BE REVIEWED

4.5.1 We agree that the Forecast BPQ should consider a number of scenarios to enable a proper understanding of the trade-offs to be made in terms of performance and cost. A base case scenario should be presented with a number of incremental scenarios. We suggest that the following scenarios will enable a sound understanding of the trade-offs:

- a 'Base Case Scenario' aimed at maintaining network security and integrity on a long-term sustainable basis (20 years plus). This would include proposals to maintain existing levels of reliability and storm resilience with incremental improvements in global performance measures and service to 'worst served' customers;

- a 'Network Improvement Scenario' involving a long term programme to reduce risk (safeguard network security and integrity) and improve network efficiency. This would include proposals to improve reliability of critical assets and enhance storm resilience. The scenario would also include initiatives to reduce technical losses; and

- a 'DG Scenario' based on the information provided in the DG BPQ.

4.6 TREATMENT OF MERGERS

4.6.1 We note Ofgem's proposals for the treatment of mergers between distribution companies. There are two important principles that must be applied to the treatment of mergers:

- merger savings must be treated like any other efficiency saving and captured via comparative analysis; and
- it is not valid to assume that merged companies will be on the efficiency frontier as there are more merged companies than non-merged companies.

4.6.2 On the issue of comparative analysis, given all the mergers that have taken place since the last review, any top-down comparative-efficiency assessments will capture the merger savings that have occurred. Any additional adjustments by Ofgem will therefore involve a double counting of these savings except in the specific context of making comparisons of non-merged companies with merged companies.

4.6.3 Comparative efficiency analysis can be undertaken in such a way as to recognise the ability of merged companies to remove duplication of overheads in certain functions. Any adjustment made to compare merged companies and non-merged companies must have the effect of treating all merged companies in the same way. Given that the overall cost base (including the fixed cost element) has been reduced since the last review, the size of the adjustment should be proportionately lower than £12.5m.

4.6.4 The Ofgem reference to merged entities being assumed to be at the efficiency frontier only makes sense in so far as merged companies would be expected to have lower costs by comparison with non merged companies (and to have lower costs before taking account of the adjustment referred to above). However this assumption is not valid given that there are now more merged companies than non-merged companies.

SECTION 5: FINANCIAL ISSUES

5.1 FINANCIAL RINGFENCE

5.1.1 We note that Ofgem is considering whether there is a need to strengthen the financial ringfence provisions that are included in companies' licences. Such changes should only be introduced for individual companies in response to specific circumstances (as was the case with Aquila). A general change, for all licensees, is unnecessary and could increase the perception of regulatory risk faced by companies and adversely impact the cost of borrowing.

5.2 SPECIAL ADMINISTRATION

5.2.1 We note Ofgem's comments on the perceived advantages of the introduction of a special administration regime for energy network companies. Our comments are in line with the response submitted by the Electricity Association to the DTI consultation on this matter. These comments are summarised in the following paragraphs.

5.2.2 The introduction of such a regime could adversely impact market perceptions of regulatory risk and generate practical difficulties, such as increasing the cost of borrowing. These problems can be minimised by ensuring that administration is unnecessary except in extreme cases.

5.2.3 Ofgem should be put under a statutory duty to take account of the functions and duties of the special administrator. This will remove the risk of the work and purposes of the regime being frustrated by inappropriate regulatory action.

5.2.4 While it is appropriate to appoint a special administrator to deal with insolvency cases, there is no justification for applying such a regime to a wider category of cases, such as breach of licence, where existing sanctions are adequate.

5.2.5 The costs of such a regime should not be borne by companies.

5.3 COST OF CAPITAL

5.3.1 We agree with the continued use of the Capital Asset Pricing Model (CAPM) to estimate the cost of capital and are in general agreement with the proposal of adopting a forward-looking approach. However, the intention to focus on overall equity returns, which is based on historical data, is inconsistent with a forward-looking approach.

5.3.2 CAPM ignores the negative 'skewing' of rate of return caused by incentive regimes such as IIP. Academic research suggests that the traditional CAPM underestimates the required rate of return because such 'skewness' is not taken into account. It is therefore important that the allowed return is set towards the upper-end of the range, rather than simply at the mid-point, to allow for this underestimate.

Provision of a Sufficient and Stable Return

5.3.3 It is important when considering the cost of capital to recognise the need to provide a sufficient and stable return to attract and retain funding from capital markets. Flexible, efficient access to capital markets is vital to enable companies to invest and deliver networks that meet the demands of future generators and consumers.

5.3.4 There are a number of key uncertainties surrounding this review, and future investment incentives would be undermined by a cost of capital that is set 'too low'. This would have serious implications on the achievement of Government energy policy targets.

Increased Cost of Capital

5.3.5 An increased cost of capital is strongly supported by market evidence, recent regulatory determinations and authoritative academic studies.

5.3.6 In October 2002, the Electricity Association commissioned an independent report from OXERA on the weighted average cost of capital (WACC) for the companies. Based on the evidence presented in that report, we believe that the real pre-tax debt, post-tax WACC lies in the range of 5-6%. For comparison purposes, using the traditional taxation adjustment of 1.429 from the last review, this would produce a pre-tax WACC in the range of 6.23-7.56% with a central scenario of 6.89%, compared to 6.5% in the last review.

5.3.7 The most significant reason for the above increase is a rise in the Equity Risk Premium (ERP) since the last review. The OXERA report argues that the forward-looking ERP should be set at a higher level than the 3.5% used in the last review, as a result of higher forward-looking stock-market volatility.

Assumptions on Gearing

5.3.8 We welcome confirmation that Ofgem will use a common assumption on gearing when estimating the allowed cost of capital. However this is not consistent with the use of company specific allowances for tax liabilities.

Treatment of Tax Costs

5.3.9 We remain extremely concerned about any proposal to change to a post-tax approach to cost of capital or to attempt to pass short-term tax efficiencies back to customers after a period of time. Such an approach would destroy medium to long-term incentives for tax efficiency and would therefore have adverse consequences for all stakeholders, including customers.

5.3.10 Ofgem must retain a pre-tax approach to cost of capital with the tax wedge set at an appropriate level. This approach provides the strongest incentive for companies to maintain tax liabilities at an appropriate and stable level. The issue of increasing tax liabilities across the industry can be adequately dealt with by increasing the tax wedge if necessary.

Treatment of Embedded Debt

5.3.11 Despite relatively stable recent trends in real interest rates, Ofgem must continue to reflect historic 'embedded' debt in the WACC calculation. A substantial proportion of efficiently incurred historical debt will have been issued at long maturities, given the long-life nature of the assets. This will incur higher interest rates than an allowance based purely on current market rates.

5.4 DEPRECIATION AND THE RAV

Depreciation 'Cliff-Edge'

5.4.1 We are in general agreement with the factors that will determine Ofgem's approach to depreciation. However, we are concerned that there is no certainty around the intended treatment of the 'cliff-edge' drop in revenue that arises as a result of pre-vesting assets becoming fully depreciated. This is a major issue and early clarity is required on Ofgem's proposed treatment.

5.4.2 The approach used by Ofgem for those companies that faced this issue at the last review must be extended to all companies at this review. That is, revenue profiles should be smoothed by accelerating depreciation for post-vesting assets. This will ensure price stability over the next price control period and beyond, and will mitigate against the short-term financial impact on companies that would otherwise result. We fully recognise that this would be an interim measure that would require to be re-examined at the next price review.

5.4.3 The alternative approach of expensing a portion of capital expenditure is not appropriate due to the large proportion of such expenditure that would have to be expensed. This would introduce a significant distortion to the incentives faced by companies. Ofgem dismissed this approach at the last review because of the distortions that would have been introduced.

Treatment of Non-Operational Capital Expenditure

5.4.4 We agree with Ofgem's proposed treatment of non-operational capital expenditure in terms of the inclusion of efficient expenditure in the RAV and assumptions on depreciation. We also agree that any efficiency should be retained for a fixed period of time.

5.5 TREATMENT OF PENSION FUND COSTS

5.5.1 We welcome Ofgem's recognition of this major issue and fully recognise that, in Ofgem's words, there can be no 'blank cheques'. However, in dealing with this issue, Ofgem must take proper account of the reasons why deficits have arisen and assess future costs in a fair, transparent and consistent manner.

5.5.2 Independent actuarial valuations will be provided to show how any deficits have arisen and to enable a projection of future pension costs. Each price control must make adequate allowance for the projected costs of providing pension benefits based on independent actuarial valuation.

5.5.3 We have two significant concerns with Ofgem's proposed treatment of this issue. These are as follows:

- the need to recognise the impact of obligations arising under the Electricity Act 1989 when making cost comparisons; and
- the need to recognise the costs of providing enhanced benefits under severance arrangements as a legitimate business cost that has resulted in efficiencies that have been passed back to customers.

5.5.4 Adequate account must be taken of the restrictions imposed by the Electricity Act 1989 (the Act) when considering efficient levels of cost and comparing costs between companies and with external benchmarks. The company inherited its pension schemes during privatisation together with obligations under the Act to protect scheme members' entitlements.

5.5.5 Our pension schemes are efficiently managed and have consistently out-performed their benchmarks over the current price control period. However, the obligations imposed by the Act do not allow the company to change the pension benefits of protected staff in any way that reduces their entitlement for past and future service. The liabilities associated with these entitlements are substantial and impose significant costs on companies. These costs must be fully provided for within the price controls.

5.5.6 The costs of providing enhanced pension benefits under severance arrangements must be treated as a legitimate business cost. It is not reasonable for Ofgem to expect companies to absorb any cost increase that results from the provision of these benefits. These benefits have enabled companies to make significant efficiencies, resulting in direct savings to customers. Ofgem's treatment of this issue must recognise the principle established by the House of Lords ruling[2], in respect of NGC and National Power, that enhanced pensions benefits on redundancy could legitimately be funded from pension fund surplus.

[2] Case references: International Power plc v Healy and Others and National Grid Company plc v Mayes and Others (2001).

5.5.7 No explicit allowance was made in previous price controls for the costs of providing enhanced pension benefits. Ofgem's statement, on page 57 in the June document, relating to an explicit allowance in previous price controls is not consistent with other statements in the same document.

SECTION 6: TIMETABLE AND CONSULTATION PROCESS

6.1 The timetable for the review is extremely challenging, providing little scope for slippage. All parties must work together to ensure delivery and enable the production of robust final proposals within the available timescales.

6.2 It is important to identify and act upon lessons learned from previous reviews and we support a review of the price review process following its completion. This review should be conducted by an independent body reporting to the Authority to ensure that all stakeholders obtain maximum benefit.

SECTION 7: REGULATORY IMPACT ASSESSMENT

7.1 We welcome Ofgem's inclusion of a Regulatory Impact Assessment (RIA) as an appendix to the DPCR consultation paper. While we recognise the initial and high-level nature of the assessment included by Ofgem, the RIA should be carried out at a level that covers the individual changes within the regulatory framework rather than considering the impact of the overall review.

7.2 This would enable all parties to have a clear understanding of the likely costs, benefits and other implications of a proposed change to any element of the regulatory framework. Such an approach would be consistent with the recommendations of the Better Regulation Task Force[3] and with guidance issued by the Cabinet Office[4] to Government departments and agencies.

7.3 We note that Ofgem will be using a log to manage risks and issues that might impact on the price review. This log should be made available to companies to aid transparency and to ensure that all relevant risks and issues are captured and given proper consideration.

[3] Better Regulation Task Force report of July 2001 entitled "Economic Regulators".
[4] Cabinet Office report of January 2003 entitled "Better Policy Making: A Guide to Regulatory Impact Assessment".

PART 2: RESPONSE TO NETWORK MONOPOLY PRICE CONTROLS PAPER OF JUNE 2003 (EXCLUDING FINANCIAL ISSUES AND EFFICIENCY INCENTIVES)

SECTION 8: GENERAL PRINCIPLES OF PRICE CONTROL REGULATION AND CONSISTENCY OF REGULATORY FRAMEWORKS

8.1 PRINCIPLES OF PRICE CONTROL REGULATION

8.1.1 We are generally in agreement with the principles of price control regulation as set out by Ofgem.

8.2 CONSISTENCY IN REGULATORY FRAMEWORKS

8.2.1 We agree with Ofgem's conclusion that it is not appropriate, at this price review, to introduce changes to the distribution regulatory framework to align with the transmission framework.

Investment at Grid Supply Points

8.2.2 We do not accept that the way in which companies are currently regulated precludes efficient investment decisions at shared sites. If there is a need, over and above our own investment priorities, to replace assets at sites shared with NGC, then this must be treated as incremental in terms of our allowed investment, and funded accordingly.

8.2.3 Where a need arises to replace some or all of the assets at a shared site, then NGC and the relevant company need to work together to find the most cost-effective solution from the customer's perspective. We have regular discussions with NGC regarding prioritisation of investment at shared sites, but have a robust independent method for prioritisation of investment.

8.3 REVIEW OF SCOTTISH TRANSMISSION PRICE CONTROLS

8.3.1 We note Ofgem's proposals on the timing of the electricity transmission price controls and the resulting implication of a one-year 'roll-forward' of the Scottish transmission price controls. We also note that consideration is currently being given to aligning the electricity transmission price controls with the gas transportation price controls, implying a potential two-year roll-forward of the Scottish transmission price controls.

8.3.2 While we can see possible merit in aligning the timing of the various price reviews, we require clarification on the roll-forward proposals in order to give this matter proper consideration. There are a number of issues that will require to be dealt with in developing proposals for a roll-forward including:

- satisfactory funding arrangements for RETS (Renewable Energy Transmission Study) investment; and
- satisfactory adjustments for the impact of BETTA.

8.3.3 We look forward to receiving Ofgem's timetable for this work in the near future and discussing the detailed proposals for any roll-forward.

SECTION 9: ASSESSING COSTS AND INCENTIVES

9.1 DEALING WITH UNCERTAINTY

9.1.1 We are disappointed with the lack of progress made on this issue. Ofgem makes reference to the framework developed by Frontier Economics and states that it will be used to aid decisions at price control reviews and, where necessary, in considering how to address new costs that arise between reviews. This framework is theoretical in nature and raises many questions regarding practical application.

9.1.2 While reassurances from Ofgem on interim adjustments and recovery of efficiently incurred costs at the next price control are welcome, they do not reduce the risk and uncertainty faced by companies. In order to remove the perception of regulatory risk associated with additional costs and new obligations, Ofgem must set out clear rules for dealing with cost increases including:

- the circumstances under which the various mechanisms (such as error correction, interim adjustments, recovery during subsequent price controls) will be applied;
- the circumstances under which pass-through will be appropriate, and those under which efficiency tests will be applied; and
- the criteria that will be used to assess efficiency.

9.1.3 We are pleased to have had the opportunity to work with Ofgem and the rest of the industry on the issue of uncertainty via Ofgem's working group. We remain committed to this working group and believe that it has a significant role to play in the resolution of this important issue.

9.2 INCENTIVES TO INVEST AND INVESTMENT UNCERTAINTY

9.2.1 We understand Ofgem's concerns in this area and fully support the need to ensure that the regulatory regime encourages appropriate behaviour from companies. This will be achieved through the creation of a climate where companies have certainty that efficient investment will be remunerated with a sufficient and stable rate of return.

9.2.2 Ofgem should continue to work with companies to assess and agree future levels of capital expenditure. A major determinant in establishing the credibility of investment plans should be Ofgem's assessment of each company's Asset Risk Management policies and practices.

9.2.3 The projected level of capital expenditure agreed at each price review should not necessarily be viewed as the possible maximum level of expenditure that a company should undertake. Significant changes to projected levels of capital expenditure should be dealt with as an interim adjustment to the price control while minor changes should, with prior regulatory agreement, be logged up for recovery via the next price control. Any logging up mechanism must preserve the net present value of the investment regardless of when recovery takes place.

9.2.4 A transparent framework is required with clear rules on the way in which investment programmes will be assessed at a price review or interim review and on the method of assessing efficiency after the event. This will reduce the perception of regulatory risk associated with investment uncertainty.

9.3 INVESTMENT DRIVERS

9.3.1 The incorporation of investment drivers or output measures within the regulatory arrangements to reduce the level of uncertainty regarding investment levels would be difficult to design and to implement. This would only be effective in areas of investment where costs and cost drivers can be predicted with some certainty and companies can influence outputs.

9.4 'SLIDING SCALE' ARRANGEMENTS

9.4.1 The type of sliding scale arrangement where some form of 'used and useful' test is applied to determine whether a company receives a higher or lower rate of return on a particular investment is not in the interests of customers. Such a regime will either encourage speculative behaviour or excessive caution.

9.4.2 In the case of distributed generation, such a regime would increase the risk and uncertainty for companies and would act as a barrier rather than an incentive for investment.

APPENDIX 1: ASSESSING COSTS AT THE LAST PRICE CONTROL REVIEW

There were a number of problems with the analysis carried out at the last price control review. The main issues are summarised below together with suggested improvements.

1. Cost Adjustments

One of the main factors driving the efficiency assumptions for companies at DPCR3 was the adjustment of each company's cost base. The largest adjustments were made to the two companies that formed the frontier and thus the adjustments to their cost bases affected all companies. While some adjustments were necessary to improve the comparability of data, the extent of these adjustments suggested that the revised data set was insufficiently reliable to conduct a robust efficiency analysis. These data issues should be improved for DPCR4 but inconsistencies will still exist.

During the efficiency assessments, Ofgem must ensure as far as possible that comparisons are on a like-for-like basis. Nevertheless, it will not be possible to remove all inconsistencies and the approach adopted will therefore need to account for this 'statistical noise'.

2. Regression Analysis

The modelling techniques used by Ofgem to identify the efficiency frontier raised a number of concerns. In particular, in relation to the following:

- The Observations

The removal of companies from the regression estimate followed by their re-inclusion to set the frontier was inconsistent. In undertaking its comparative-efficiency analysis for DPCR4, Ofgem must consider whether some companies are 'outliers' and ensure that valid comparisons are made. Quantitative approaches are available to identify whether companies should be considered as statistical outliers.

Ofgem must undertake analysis to examine how sensitive the results are to different assumptions. Results that are highly sensitive to different assumptions would not be robust enough to be used in the price control review.

- The Cost Drivers

Ofgem's use of a composite scale factor was not standard econometric practice. More standard statistical approaches could have been used to establish a composite variable; however, even these would tend not to be used in an econometric setting. The main concern is that such a small data set does not allow enough exogenous factors to be taken into account in the comparative-efficiency modelling. Ofwat allows for such factors by incorporating company-specific factors into the analysis. Ofgem should give greater consideration to such factors in DPCR4.

- The Identification of the Benchmark

The rotation of the regression estimate about a fixed constant term was not justified and had an unduly significant impact on the efficiency estimates. The estimated efficient benchmark was therefore entirely dependent on just two or three points (the estimated constant and Eastern / Southern's position). The position of Southern and Eastern could be criticised based on the construction of the composite scale variable and their cost adjustments.

Several alternative approaches are available to construct a benchmark. Whatever the approach adopted for DPCR4, it will need to take into account data inconsistencies, comparability, modelling errors, the omission of company-specific factors and cost drivers, incentives, etc.

3. PKF's Bottom-up Analysis

Ofgem placed considerable weight on the benchmarking study by PKF. Some adjustments (e.g. for double counting) were arbitrary. We would hope that such simplistic assumptions are not part of DPCR4. The following are some of the main criticisms of PKF's analysis.

- Transparency

The approach lacked transparency and the data set was not circulated during the review. This made it impossible for companies to examine properly the conclusions drawn from the data. We welcome Ofgem's intention to ensure transparency of approach and would emphasise that this must include sharing its data sets with the companies involved.

- 'Cherry Picking'

'Cherry picking' occurred because of the problems of cost allocation and because the cost allowances for individual companies were built up from a number of sub-categories using different companies as the benchmarks in each case. This meant that the overall estimated efficient cost level was hypothetical and would not have been achievable by even the most efficient company. This problem can be avoided by assessing relative efficiency at an aggregated level.

- Ratio Benchmarks

The ratio benchmarks were over-simplistic, as differences in other cost drivers between companies were not taken into account, and the fixed-cost estimate was inconsistent with Ofgem's own assessment. When comparing alternative approaches it will be important for Ofgem to understand the reasons for the differences between the results, such as omissions or limitations of the techniques used.