CE Electric UK

Your ref

Our ref MJH/LC/150

Our Ref:

Your Ref:

Date: 10 October 2003

Chris Chapman
Head of Planning
The Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Dear Chris

OFGEM'S THREE-YEAR STRATEGY 2004-2007

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL). The views expressed in this letter represent those of CE, NEDL and YEDL.

We are grateful for being given the opportunity to comment on the strategic choices that the Gas and Electricity Markets Authority must make over the coming years.

We appreciate that the Authority has functions beyond the regulation of network industries but in this reply we shall focus upon those areas of the Authority's activity that affect our own electricity distribution businesses.

Key challenges facing the industry in the short to medium term

The industry has developed significantly in its period under regulation and, as it has done so, the challenges that have faced it have, themselves, developed. In addition to the 'perennial' challenge of finding ways to increase the efficiency with which we deliver excellent service to a customer base whose expectations are constantly rising, there are some particularly pointed challenges that are now emerging as priority issues for distribution network operators (DNOs). These challenges distinguish themselves from many of those faced in the past for two principal reasons:

- they relate to securing renewal and change in the underlying components of the DNO, namely its asset base and its workforce; and
- they are actually long-run challenges that require measured action in the short-medium term.

The asset bases that the DNOs are operating are now entering a period of asset renewal, and managing the implications of that is a central consideration for their boards. Although there will be much debate in and around the industry about the precise extent and details of this, there is no debate that the DNOs are now entering a phase where investment levels in their assets are starting to steadily, but noticeably, increase relative to historical levels. This will be a long-run process, but it must be properly handled in the short term

CE ELECTRIC UK FUNDING COMPANY

Lloyds Court, 78 Grey Street, Newcastle upon Tyne NE1 6AF. Tel: (0191) 223 5151. Fax: (0191) 223 5152.
Registered Office: Lloyds Court, 78 Grey Street, Newcastle upon Tyne NE1 6AF. Registered in England: 3476201.

to ensure that the required outcomes are achieved. There is little doubt that expectation in the stakeholder community is that the result ought to be **improved** performance in terms of reliability, power quality and resilience. Simple maintenance of existing levels will not be an adequate performance.

Renewal of the existing network is not the only asset-related challenge that faces the DNOs. The drive to increase the proportion of energy generated by renewable, distributed sources has deep significance for distribution networks. In conjunction with the underlying requirement for managed, efficient asset renewal, the DNOs must also face the demand to translate their existing networks into generation-rich, active networks.

These two areas of asset-related challenge carry with them a third, consequential challenge. Without exception all DNOs have seen their workforces reduce radically from pre-privatisation levels. This has been an important and necessary step as companies have been challenged to deliver significant efficiency gains. As it stands now, recruitment into the industry has been virtually non-existent during the period of efficiency gain, and every company is facing an age-profile in its workforce that has similar characteristics to the one displayed by its asset base.

Looking to the future, with the demands discussed above, maintenance and renewal of the human resource asset of the organisations is set to be a significant success factor. It is imperative that the industry is able to respond to the demands for resources that will flow from the requirements discussed above. As investment levels and the complexity of the networks increase, the need for an adequate number of skilled resources, in the industry as a whole, is a significant long-term concern.

All of these factors are challenges that are present now, and will remain so for some time. Without doubt, the principal challenge that lies ahead in the short to medium term is the carrying out of the fourth distribution price control review (DPCR4) in such a way as to ensure that licensees:

- are able to make positive strides in the period 2005-2010 towards meeting the challenges of asset and workforce renewal discussed above; and
- continue to be able to finance their activities and comfortably maintain their investment grade issuer status.

It is a challenge for both the licensees and for Ofgem to ensure that this review successfully overcomes the shortcomings of previous reviews. Given the long-run nature of the challenges that the industry faces, the short-term imperative is to execute a price control review that incentivises those behaviours that are compatible with good performance in **both** the short and long term.

Actions that the Authority should take to respond to these challenges

DPCR4

None of the drivers and challenges described above diminishes the need for companies to perform efficiently, and hence for Ofgem to effectively assess (and reward) efficiency within the sector. If companies fail in their responsibility to perform efficiently, then the shareholders and/or the customers suffer the consequences. The same is also true if Ofgem fails to deliver a robust, transparent and reliable assessment of efficiency since prices might be higher than necessary for a period. However, of greater concern would be the other extreme in which the method used by Ofgem placed undue reliance on inconsistent data and/or established frontiers or benchmarks using comparators which masked unacceptable underlying risk.

At the last price control review Ofgem relied heavily on comparative methods to determine the allowed income of DNOs. We now know that the data that was used for these comparisons varied significantly between companies and that the results were, therefore, invalid for the purposes of making fair comparisons to determine allowed income. If Ofgem is to use comparative data to inform the next price control settlement, then it needs to invest a great deal more effort in ensuring that the data that Ofgem has relating to each company is truly comparable.

Even when the data used to inform the comparisons is consistent across the companies, the use of comparators to determine allowed income introduces the likelihood that the regulatory method will not incentivise the correct behaviour on the part of the regulated companies. If the company judged to be the most efficient is simply the lowest cost, and has achieved these lower costs by accepting risks that, actually, are ill-advised for both themselves and indeed the rest of the sector, then the regulatory process would have introduced entirely the wrong incentive on the group of regulated companies.

Hence, if Ofgem is to continue to place such a high degree of reliance on comparators as a principle means of price regulation, then it is essential that it invests more effort in two key objectives:

- establishing robust and comparable data sets; and
- ensuring that the cost-risk-performance profile of any companies used to "set frontiers" is properly understood to represent a sustainable position.

Our own view is that Ofgem ought to engage greater effort in understanding companie's own performance, through developing still more effective bi-lateral discussions with the licensees. We would like to see Ofgem place an increased reliance on such exchanges in the forthcoming price control review, as opposed to relying too heavily on comparative analysis that is still subject to the significant risks outlined above.

The dangers inherent in such reliance on the comparative approach are obvious. They are compounded by the fact that the consequences of neglect, or the taking on of extra risk, are not apparent within the timescales of a price control review. It is interesting to note that one of the companies that represented the efficient frontier at the last price control review had difficulties in responding adequately to the storms of October 2002

The output measures and asset risk management (ARM) assessments may have a useful part to play in providing some reassurance to Ofgem, but we do not believe that these have been developed to the point that is necessary to balance the clear dangers inherent in using comparative methods that rely on the use of frontier companies to determine the efficient costs of other companies.

These drawbacks suggest that Ofgem needs to conduct price control reviews with much greater focus on the reality of each licensee rather than by relying upon an efficient frontier. To the extent that comparisons can aid the regulator's understanding of a particular company, Ofgem needs to invest effort in developing a consistent data set across all DNOs.

The value of comparative data is likely to increase if it encompasses the totality of costs incurred by DNOs. This is partly because companies face real choices between operating and capital cost solutions, but also because the categorisation of costs differs between companies to an extent that we now know was not properly adjusted for at DPCR3. Total costs approaches have the merit of removing or diminishing this difficulty. To date relatively little has been done to develop total costs comparisons. If Ofgem is to use comparative data at this review it is important that a total costs methodology is developed during the next few months.

Distributed Generation

In the period before commencement of the next distribution price control it will be vital for interim incentives to be introduced for DNOs to support distributed generation connection. No less important will be the provision of early signals of the nature of the arrangements that are expected post-2005. These arrangements will need to establish meaningful and effective incentive arrangements that encourage the right commercial behaviours by DNOs, such as economic management of the network and processes that establish generator connections as quickly as reasonably practicable. Pre-requisite to the success of such arrangements will be recognition by Ofgem of the need to establish effective arrangements for the ever-increasing need for DNOs to manage counter-party risks and to reflect these additional risks in the assessment of the cost of capital to be applied to DNOs.

New areas of work that should be set in train and the priority to be given to these

We believe that most of the important areas of work are already underway within Ofgem's current plans. We believe that greater priority (in terms of effort and senior commitment as opposed to timescale to complete) should be given to the following:

developing a better understanding of the business of each DNO, including its historical performance and future plans;

development of a consistent data set across the DNOs that relates to the information and the assumptions on which price controls have been or will be set;

development of meaningful and effective incentive arrangements to encourage DNOs to accelerate the process of addressing the technical issues, the customer liaison and the investment planning techniques that will need to change to deliver increasingly generation-rich networks;

development of a long-term vision for distribution network operation, embracing in particular a review of common ground between distribution and transmission (with clear customer benefit the key criterion for any alignment);

development of a total costs benchmarking methodology;

development of alternatives to comparator-based methods of regulation; and

development of a method of remunerating pension costs that can be implemented at the next and subsequent price control reviews.

Work that should be given less priority or even stopped

It is not clear to us that the work being carried out on the regulatory accounts is likely to yield much that is beneficial in the regulation of the DNOs. This is because what Ofgem needs is not a set of regulatory accounts, in the conventional sense, but an understanding of the performance of each company compared with the price control assumptions. Rather than try to develop the regulatory accounts to serve a purpose for which they are unsuited, we recommend that Ofgem divert this resource into developing an annual return that gives Ofgem the information it needs on a consistent basis.

I hope that you will find these comments helpful. If you would like to discuss any of them, please do not hesitate to contact me.

Yours sincerely

Mark Horsley

MARK HORSLEY
President & Chief Operating Officer