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Our ref	*Your ref*	*Date*
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Dear Nienke

CEPA's Report on Benchmarking (Background to Work on Assessing Efficiency for the 2005 Distribution Price Control Review)

I am providing the following comments relating to CEPA's report on benchmarking on behalf of both Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc.

The purpose of benchmarking is to enable Ofgem to form a view of what each DNOs costs should be for a given level of performance. What each DNO's costs should be for a given level of performance will depend on the details of the network operated, the terrain in which the network is situated (including for overhead networks the number of trees), the demographics of the area served and the weather encountered. In order to set the benchmarks for both performance and cost these factors need to be taken into account on a "bottom-up" basis – so that the causes of costs can be directly taken into account when assessing efficiency. WPD's presentation to Ofgem dealing with cost drivers is attached as an Appendix to this letter.

Statistical/econometric techniques may be useful as a comparative cross-check to benchmarking once the actual cost drivers have been established and understood but these techniques are secondary.

The CEPA Report

It is clear form the CEPA report and other work which has been performed on the calculation of comparative efficiency that there is no one method or combination thereof which will provide a completely reliable result – the techniques are secondary rather than primary in assessing the costs needed for a given level of performance. We therefore agree with the conclusion of the report that an element of

judgement based on a wider range of evidence will be required in formulating the proposals for the next price control period.

The report highlights results for companies at both ends of the efficiency scale that are difficult to understand using statistical techniques

If a regression/frontier, rather than an average benchmark approach is taken to setting the next price control the position of the frontier company is of vital importance to all DNO's. The frontier should be based on a performance assessment based on reliable benchmarks of both cost and performance

Input data

Two of the key issues highlighted in the CEPA report are the possible use of either international data or panel data. A number of the measurement techniques assessed by CEPA would benefit from an increase volume of data. However the use of international data will introduce a tranche of data that may not be comparable with the UK data being used. Different operating conditions, regulation, industry structures and accounting practises may all make comparisons invalid. For example, in some countries the Distribution business undertakes what would be supply business functions (eg customer billing), standards of engineering differ between countries, as do network configurations and primary operating voltages)

Panel data would also provide additional data for analysis purposes and overcomes some of the problems with international data. However it is clear from the work that has been done on the 2002/03 data that it is difficult and time consuming to provide a good quality dataset for one year. Inclusion of additional years of historic data is more likely to introduce spurious outcomes to the analysis. The availability of data on a consistent on comparable basis is a desirable aim for the future.

Benchmarking techniques

WPD's view is, in simplistic terms, that the business of DNO's is to maintain, renew, extend and operate the assets of a distribution network. As a result the principal cost driver for variable costs will be the amount and nature of the assets and the environment within which they are operated. The proposal in the CEPA report a two variable composite including network length and units distributed is partly in agreement with our view that network length (as a proxy for assets) is the most appropriate cost driver for a distribution network. We do not agree that units affect variable costs and no explanation of how units affect costs has been provided. The provision of reliable distribution network, of sufficient capacity, is the chief function of a distribution business and network length is the best measure of this. Network length may also be thought of as a proxy for customer sparsity which is a cost driver in the South West but is not included in the COLS/DEA methodologies.

It is recognised in the CEPA report that the result of DEA analysis is sensitive to the choice of input and output variables and has a number of other significant

disadvantages. The results of the DEA analysis may be difficult to explain and include no measure of statistical significance. The COLS technique gives measures of statistical significance and can exclude variables that are not relevant that may be given undue weight if the DEA model is unconstrained.

In particular the fixed cost element is subject to volatility when either a DEA or COLS technique is used. A bottom up approach to determining fixed costs reduces the unreliability of the prediction of the fixed cost.

Where DEA models are used the input form seems to be most appropriate for a distribution business.

The most important limitation on statistical/econometric techniques is that they do not make direct reference to a given level of service and are therefore limited in their validity as assessments of efficiency.

Please contact me if you would like to discuss our comments further.

Yours sincerely

R G WESTLAKE
Regulatory & Government Affairs Manager