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19 November 2003

Dear Nienke

### **Electricity Distribution Price Control Review – October Update**

This letter, together with the attached paper, gives EME's comments on the October update paper.

The attached paper comprises detailed responses in each of the areas requested and follows the order of the consultation. These are the responses we wish to highlight here:-

#### *Rolling Capex Mechanism*

We maintain our support for the intention to allow DNOs to retain capital efficiency savings, but further consideration of the outline mechanism, in particular, of the treatment of "efficient overspend", has made us question whether this is an appropriate way forward. We believe further debate would be useful here and would welcome the opportunity to discuss this with Ofgem directly.

#### *Consumer Survey*

Notwithstanding our comments on Stage 1 of the consumer survey here and in a separate, fuller response, we do believe that Stage 2 is an opportunity to determine and demonstrate the extent of consumers' support for targeted investment.

We must emphasise, though, that care is required in the survey design if robust findings and conclusions are to be made.

#### *Inter-company Quality of Supply Benchmarking*

There are a number of problems currently with the data and measures relating to quality of supply, and they are currently an unsuitable basis for directly comparing DNOs.

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Although there is a fuller role for such comparisons in the future, while robust data is at its embryonic stage, we believe the current benchmarks are best used to set an overall direction or bearing, by which longer-term quality of supply targets can be explored.

#### *Distributed Generation*

The future for distributed generation (DG) is characterised by significant uncertainty and DNOs' projections of volumes and costs reflect this. We believe this presents short-term difficulties for Ofgem's proposed incentive mechanism, and that, until we have a better understanding of costs, we would be better working with an incentive based on separate capital allowances for DG with an appropriate rate of return.

We also believe that the RPZ mechanism could be made significantly more attractive if RPZ areas were removed from the calculation of general network IIP and GoS penalties.

#### *Assessment of Costs - Comparative Analysis*

We welcome Ofgem's intention to use a variety of analytical techniques, in particular, to include total factor productivity analysis.

We believe none of the proposed techniques will provide unequivocal, statistically robust findings, but they will prove helpful as a prompts for informed discussion.

We welcome, in particular, in this regard, Ofgem's commitment to undertaking the process with judgement, pragmatism and transparency.

#### *Pensions*

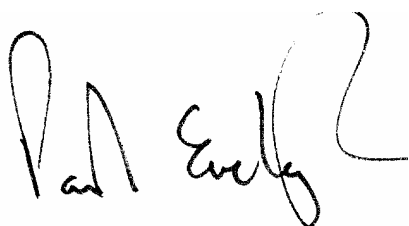
A DNO has significant legal liabilities, the vast majority of which were incurred as a regulated business, and for which customers have received benefits in the past.

We should also point out the inclusion of an additional note at the end on an issue which is becoming an increasing concern to DNOs, but which was not covered in the October update paper; tax.

Finally, we are pleased to see that progress continues to be made in this price control review with minimal slippage in the timetable.

We now look forward to the December update.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Paul Eveleigh', with a stylized flourish at the end.

Paul Eveleigh  
Commercial & Regulation Manager

## **DPCR4 October Update Response**

### ***Form, structure and scope of the price controls***

3.38. Views are invited on any of the issues in this Chapter and particularly on:

- *the application of the rolling adjustments for opex and capex; and*
- *the losses incentive.*

### **Rolling OPEX**

We repeat our support for this improvement to the incentive for operational efficiency.

We believe there are still a couple of issues which need to be addressed:-

- The treatment of savings made in this review period needs to be formally “pinned down”. We presume Ofgem do not wish to go through the drawn-out process of making licence modifications, which will undergo more significant change before long.
- Clarification is required on how inflation is to be allowed for.

We would also like to point out that the Ofwat methodology, on which these proposals are based, has recently been improved. The DNO Price Control Group is assessing the changes with a view to adapting them for electricity distribution. A joint DNO submission is likely to be made to Ofgem in the near future.

### **Rolling CAPEX**

We welcome acknowledgement in the update paper (paragraph 3.26) that an “overspend” in capex during the current period will not automatically rule out application of the rolling adjustment. However, we also note that there is no detail yet on how the mechanism will work if an “overspend” occurs. Consequently, it is difficult to judge whether the mechanism will be flexible enough for an “overspend” to be deemed efficient and then be treated equitably when compared to the reward implied for an “under-spend”.

We believe that it is essential that the mechanism is developed so that any “overspend” identified as efficient can effectively be ring-fenced. This will facilitate its addition to the RAV in due course, without affecting judgements of the efficiency of any remaining “under-spent” investment.

It will also be for consideration whether an adjustment can be made to compensate for the financial implications of the delay in adding an efficient “overspend” investment to the RAV five years later

On further consideration, however, we believe the treatment of “overspend” may reveal fundamental difficulties with the rolling capex concept. There are aspects to this which potentially make it an unsuitable incentive and reward mechanism for an environment where efficient investment of the full five year allowances is to be encouraged.

From a regulatory perspective the capex allowance has always been seen and managed as a single total amount for the whole price control period rather than as a series of individual year-by-year allowances. We believe this has allowed DNOs to act flexibly and enabled them to make capital investments efficiently.

Although there are different drivers for load-related and non-load-related investment, there is also an element of overlap, particularly with regard to “replacement” for general load reinforcement and the need for replacement on condition. By treating capex as a single

amount, previous price controls have implicitly recognised this and effectively allowed DNOs freedom to find the most efficient mixes of capex.

In addition, although year-by-year profiling has been applied to capex in these categories, its main purpose has been to help set the revenue streams available to the companies.

Profiled spend has usually borne little resemblance to the timing of actual capex investments in both load-related and non-load-related categories. Although changing costs have affected this divergence, it has mainly been the result of DNOs adapting to changing circumstances. Again, we believe the treatment of capex as an amount of money to be spent over a period of five years has given DNOs the flexibility to adapt investment plans in response to change and so helped them develop and deliver their capital programmes efficiently.

The proposed rolling capex mechanism, with its implied yearly reviews of expenditure and efficiency, may threaten this.

We contend that, whether concerned with “over-” or “under-spending”, judgements of capex efficiency based solely on variances from year-by-year profiles will be flawed and counter-productive. Indeed, irrespective of the validity of any subsequent judgements, there is a danger that the investigation of variances would become a bureaucratic exercise, a detailed and time-consuming audit of outturn and forecast volumes and unit costs.

We believe the flexibility inherent in viewing the capex allowance over a five year period compared to individual years must not be lost in any improved capex incentive. We also believe that capital spend should be reviewed against the total capital allowance, and not be disaggregated for this purpose, even in terms of load related, non-load related and metering.

Importantly, EME accepted the capex allowance for the current review period in total. Indeed, in subsequent discussions with Richard Ramsay, we agreed that any savings in metering capex would be used as part of the overall allowance to improve the network. We therefore cannot understand the exclusion of metering capex from this control period’s rolling capex adjustment.

In general, however, we believe the concept of rolling capex adjustment is more suited to a world in which long-term investment programmes are well established and companies are incentivised to deliver anticipated volumes but at lower-than-anticipated unit costs.

We consider that the UK industry is moving towards an environment in which the allowances should be viewed essentially as amounts of money to reinforce and replace an already-aged network. Under this paradigm, efficient delivery will allow further work to be carried out until the allowance is fully invested. Efficiency in this type of scenario is virtually impossible to judge on the basis of money variances alone.

In summary, we consider that the issues of “overspend” and related efficiency judgements may nullify the incentives and rewards implied by the use of the rolling capex mechanism. We believe there is a need for further debate of these issues and we would welcome the opportunity to discuss them with you.

## **Distribution Losses**

Ofgem appear to have taken an unnecessary step backwards in this section of the paper – proposals in a previous consultation were more detailed than those here. We were happy with the outline given previously and were hoping that this update would clarify the remaining details of the proposed incentive (except the value of the incentive in pence per unit), and that we

would therefore be able to understand its likely impact on our revenue stream and hence gauge our future ability to fund loss reduction measures.

Given the amount of work still to be done in the review generally, we believe Ofgem have missed an opportunity to get at least one issue more or less settled.

We accept that the value of the incentive will be better determined nearer the date of implementation, so as to take account of the latest information on electricity wholesale prices, ROCs etc., but believe the remaining details of the incentive could have been clarified at this stage. Saying that, "...the form of the incentive should be based on that proposed for operating costs" is of limited use to us. In particular, it would be helpful to have clarity on how the targets will be set, how any 'rolling adjustment' will work, and how targets will be updated at subsequent price control reviews. In addition, to ensure that the incentive is fully understood, we think it essential that a detailed worked numerical example is provided.

We do not believe significant further conceptual work is required here. We support the losses incentive scheme framework outlined earlier and urge Ofgem to complete the remaining detail. We hope this will be forthcoming in the December consultation paper.

## **Quality of service and other outputs**

4.37. Views are invited on any of the issues in this Chapter and particularly on:

- *the results from the first phase of the consumer survey;*
- *measurement and incentives in respect of network resilience;*
- *the approach to disaggregating and comparing quality of supply performance;*
- *the scope of the output incentive scheme for the next price control period; and*
- *changes to the standards of performance arrangements.*

## **The Consumer Survey**

A full response to the consumer survey has been sent separately. This is a summary of our main observations:

- The decision to bias the sample to capture the experience of consumers who have experienced outages undermines many of the detailed findings.
- Consumers are generally satisfied with their electricity supply, with only a minority expressing concerns, even when prompted to do so.
- On an interruption in supply, consumers are more concerned about receiving good information and speedy resumption of service, rather than some form of payment.
- The indications of “willingness to pay” need to be explored more robustly, in particular, by giving consumers choices that involve realistic trade-offs.
- The stage 2 part of the study needs to be designed carefully if it is to capture robust information on willingness to pay.

Although we are critical of the survey so far, we do believe that stage 2 is a valuable opportunity to demonstrate any basis of consumer support for targeted investment.

## **Network Resilience**

We agree with Ofgem’s view that network resilience (perhaps better understood by the term “storm proofing”) is a multi-dimensional concept, comprising two key features:

- The reliability of the network during extreme conditions;
- The time taken to restore customers interrupted during extreme conditions (this, it should be noted, will be different from the time taken during normal conditions because of the volume of incidents, the resources available and, more often than not, safety constraints).

We believe great care needs to be taken in thinking about incentivising investment in network resilience.

For instance, it is not clear to what extent consumers want it. The recent customer survey found that customers are tolerant of supply interruptions during extreme conditions. Phase 2 of the customer survey may, of course, help answer this question.

There will be difficulties in establishing whether or not investment, made on the grounds of improving resilience, is effective. This is simply because individual “storm-proofed” parts of the network may never again be affected by the extreme conditions, which prompted the investment.

And there are difficulties in developing a usable, whole-network measure of resilience. Network reliability, a measure of the network under normal conditions, is, in principle, a relatively simple measure to make, usually expressed as faults per km. However, it is an aggregated measure, taking into account the numbers of faults in a variety of dimensions, for instance by voltage level and by asset type (e.g. overhead line) and is inherently variable.

The reason this poses a problem for a usable measure of resilience, which is reliability or faults per km under extreme conditions, is that “storm proofing” investment is always “small” investment relative to the whole network. As a consequence, even “storm-proofed” network which is successfully tested by repeat extreme conditions will not be identifiable in a whole-network measure, because any changes in the localised faults per km measure are effectively swamped by all the other measures which make up the aggregated value for normal network reliability.

In effect, we believe a usable output measure of network resilience is extremely difficult to derive in practice.

However, we should point out the ongoing work of the industry Network Resilience Working Group, which we continue to support and participate in, and which is addressing issues such as this. It is likely that this group will make proposals for targeted increases in investment in this area.

In the meantime, in the absence of current recommendations, we believe that, if improvements in network reliability during extreme conditions are desired, it will be necessary to devise some kind of input measurement or control, probably relating to a specific investment programme targeted at areas identified to be at risk.

## **The approach to disaggregating and comparing quality of supply performance**

### *Approach to Disaggregation*

The approach outlined on comparison of quality of supply provides a foundation, which can be built on. However, as we said in our response to the July Initial Consultation, we consider that any proposal for comparing quality of supply, whether it is based on disaggregation or some other methodology, needs to follow two key guiding principles:

- It must use a sufficient number of years of RIG-defined, compliant network performance data so that the natural variability in network performance can be taken into account
- It must use a robust methodology that captures the relevant variables.

The proposal outlined in the update paper is essentially a form of benchmarking. Before any benchmarks are used in this area there needs to be confidence in their validity. In particular, to ensure consistency and accuracy across the industry, we believe there needs to be several years' worth of data, based on clear definitions and supported by an auditable process.

Unlike the performance data, which is covered by published RIGs, the data for physical parameters lack common definitions. Indeed, even the concept of “a circuit” is not defined, and this leads to dissimilar types of network being grouped together. We believe that until the data has the safeguards suggested above, the benchmarks should be used with extreme caution; any direct comparison of companies will be misleading. Indeed in section 4.27 of the update paper it is acknowledged that more data is required and we support this view.

Finally, the process outlined in the paper is based on an embryonic methodology, the robustness of which is still to be proven. Statistical work that we have undertaken indicates that the variables used explain only 25% of the variability observed and again we would therefore urge caution in using the information.

### *Comparing Quality of Supply through the use of benchmarks*

For the reasons stated above we consider that the benchmarks identified and used through the re-aggregation process are unsuitable for **directly** comparing companies' performance;

detailed supporting explanations of the underlying reasons for any differences would also be needed.

We do, however, support the idea that the benchmarks can set an overall direction or bearing and so provide a base from which the longer-term quality of supply targets can be explored. We therefore welcome the opportunity to consider the investment required to enhance distribution networks to deliver the targets so identified and to provide the foundations for the longer-term, 2020 targets. However, we would like to point out that the 2020 targets still need to be judged against views from the customer willingness to pay surveys together with a societal view of performance requirements in the major customer and network groups e.g. rural, mixed and urban. Without this work there is considerable risk that investment plans to deliver the long-term targets could be sub-optimal and deliver unwanted “benefits”.

We also note that no benchmarks are set for the process for planned interruptions. As these have different drivers to unplanned interruptions, we support this approach. We consider that it is more appropriate if companies’ forecast planned interruption targets deal with this as part of their investment submissions.

### **Rewarding frontier performance**

Section 4.27 implies a reward mechanism, though the actual mechanics are unclear, which appears to be based on an improvement in performance relative to the benchmarks during the current price control period, regardless of whether IIP targets are met. For the reasons stated above we believe the disaggregation process is unsuitable for rewarding frontier performance during the current price control period.

It is also difficult to understand whether or not the reward of frontier performance is in place of the current IIP or additional to it.

Notwithstanding our views with respect to using benchmarks to drive a reward scheme for frontier performance, if this is intended as a replacement for IIP, then we consider this would be a re-opening of already-determined special licence conditions. At this stage in the current price control, with a need for a due consultation process, we believe this is not a feasible approach. It has the potential to lead to confusion over just what the performance targets are, and, of course, it is too late to take action to influence the performance of the network.

If it is intended as an addition to IIP, then we consider that this is not in the spirit of the final agreed form, which indicated that frontier performance (however it was defined) would be part of the next price control period, not the present (ref: IIP Incentives Final proposals 2001).

Finally, we consider that the embryonic benchmarks, even if improved in the ways suggested, and even though they may be suitable for comparative purposes, are not suitable on their own for the reward of “frontier” performance. As the paper states, network performance is mainly dependent on inherited and inherent characteristics. Companies have virtually no opportunity to realistically improve on the benchmarks, particularly in that of customer interruptions, over the current price control. Any improvement so identified is likely to be more a function of the process being used than of real improvements for customers. We reiterate our response to the initial consultation; quality of supply is inextricably a cost/quality trade off and extreme caution is required if the benchmarks are used without a cost signal to identify frontier performance.

To summarise, we support Ofgem’s view that the methodology outlined has a use in setting long term targets. When linked to capital investment we would consider that this is an appropriate way to reward companies during the next price control period. However, we strongly suggest that IIP remains intact during the present period and that the disaggregation



process is used only to inform the investment required to achieve targets for the coming price control period and beyond.

### **The scope of the output incentive scheme for the next price control period**

We consider that network reliability needs to be incentivised but that it is inappropriate to use it as a replacement for the IIP scheme. As already mentioned in our response to network resilience, there are difficulties monitoring reliability because of the inherent variability under both severe and normal weather conditions. We believe that further work in this area is necessary, building on the work undertaken by the joint Ofgem/DNO working group on Quality of Supply. We believe that linking fault-volumes to investment plans and incentivising through the RPI-X mechanism of the price control is an appropriate way forward in the meantime.

The current incentive scheme uses “spot” targets. As we have stated in past consultation responses, any target setting needs to take account of the inherent variability in network performance. “Spot” targets imply that networks need an even lower underlying level of performance in order to ensure delivery of the “spot” target. We consider that a method of accommodating the variability either through the application of dead-bands to the targets or by taking a two/three year average performance is preferable to this approach. Companies may be able to influence the underlying trend in performance through consistent improvement, but the nature of electricity distribution means there is insufficient control to achieve absolute targets year on year.

### **Changes to the standards of performance arrangements**

We stressed in our response to the initial consultation that the proposed change to the threshold of the “multiple interruptions guaranteed standard” (currently 4 or more interruptions each longer than 3 hours) would prevent us from being pro-active or having adequate control over performance levels. We believe that Guaranteed Standards should be set at levels that are attainable, rather than at a level where companies are expected to fail, otherwise it provides no incentive other than to achieve the efficient level of compensation payment allowed in the price control.

We also note that the update paper implies that the customer survey elicited a general view that too many interruptions were required to trigger the MI GS. However, the survey found that “72% of respondents felt that 4 or more was about right”. As customers would rather not have multiple interruptions than receive payment for them, the survey actually seems to give a strong indication that the standard should remain at the current threshold.

### **Additional Note – An Incentive For Shared Best Practice?**

Finally, we should also like to point out that there are little or no material incentives for DNOs to share resources or best practices. Of course, the comparative approach favoured by Ofgem militates against co-operation amongst DNOs. However, given our similar purposes and consumers’ general expectation that there should be no regional variations in DNO service and performance, we think at least some consideration should be given to developing an incentive which rewards all DNOs for improvements in average aggregate performance.

## Distributed generation

5.28. Views are invited on any of the issues in this Chapter and particularly on:

- the summary information on the volume and costs of distributed generation;
- the incentive framework for distributed generation and in particular:
  - the proportion of costs that should be passed through;
  - the best of way of incentivising DNOs to provide network access to distributed generators on an ongoing basis; and
  - whether similar arrangements could be applied to demand customers;
- interest in IFI Category C activities and the potential benefits of providing funding for them; and
- from DNOs, examples of the opportunities they anticipate for RPZs. This will enable us to test our proposals against a more realistic set of examples and will assist us in refining our thinking. These proposals could be conceptual or related to an actual part of a DNO system and will be treated in confidence if requested.

## Summary Information

The future for distributed generation (DG) is uncertain. Although DG continues to receive active encouragement from both within and without the electricity supply industry, the depth and extent of its future take-up remains unclear. DNOs, in particular, have been asked to forecast the impacts on network costs of something which has inherent complexities and which, in the anticipated numbers, is significantly new to them. And the question has been posed in the context of a likely change in their connection-charging regime and the introduction of a promised but unspecified incentive mechanism, both of which are intended to encourage DG and, as such, “loop back” to the question on costs.

DNOs have every reason to be uncertain about DG and its impacts and we believe the summary information reflects this.

Figure 1, which is based on the information in the summary table, depicts DNOs' views of the £/kW costs of connecting DG for the historic, interim (DR3) and forecast (DR4) periods and shows two things, a significant rise in predicted costs and a projected increase in the *spread* of costs amongst the DNOs.

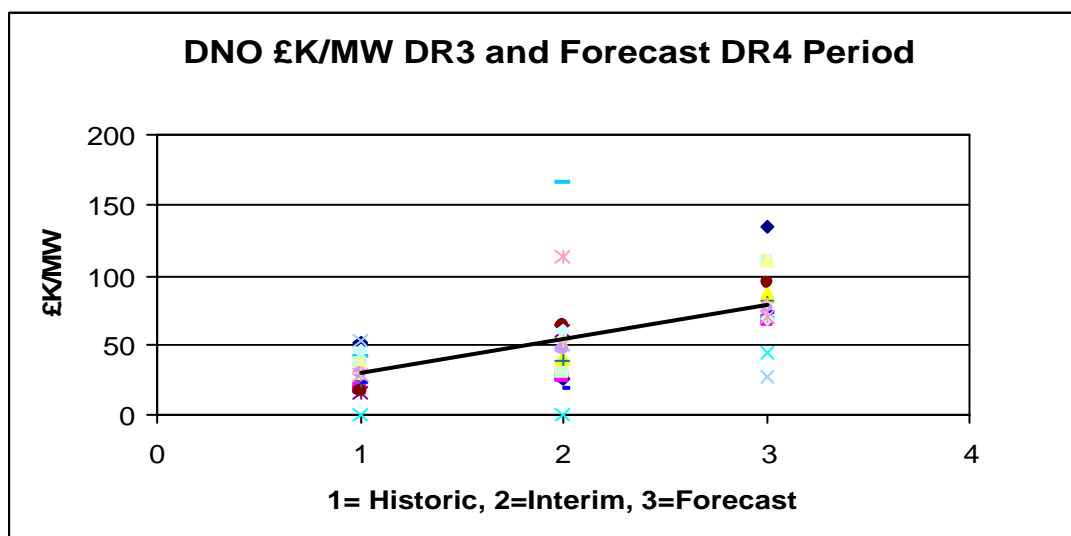


Figure One – Submitted DG-BPQ DNO historic, interim and forecast data

These two types of change may turn out to be true. Network costs, on the whole, are expected to increase as a result of DG penetration, and costs will almost certainly vary by DNO area.

However, even accepting that changes occur in the directions indicated, we doubt that this picture reflects the actual *magnitudes* of future cost changes.

DNOs' costs in the historic period are relatively close, but, as we move into the future, costs increase and spread, and we contend that these changes reflect less confidence and increasing uncertainty as much as changes in real or likely costs.

We do not believe the UK has experienced enough penetration of DG to give a reliable picture of costs.

This is important, because we also believe that further DG penetration and cost information is needed before implementing the hybrid-type of incentive mechanism that Ofgem is recommending.

We contend that current £/MW figures are not really robust enough, and further, that if the spread of DNO costs turns out anything like as indicated, that a single hybrid formula applied to all the UK DNO's is likely to be unsuitable.

### **The Incentives Framework**

We repeat the view we expressed in our response to the previous consultation document, that, due to the infancy of DG within the UK and the need to encourage its development, whilst accommodating locational cost signals, the incentive mechanism for DG should be clear and simple.

We do not, therefore, favour incentive mechanisms that are dependent on particular technologies, penetration levels or which promote DG without regard to location.

### **Hybrid Incentive Mechanism**

EME believe the proposed hybrid incentive mechanism *could* be a suitable formula for the efficient and effective connection of distributed generation when better information is available to inform the £/MW incentive rate.

As stated above, we believe at the present time this is not the case and any incentive mechanism which uses a £/MW figure is likely to be inappropriate.

Under the current conditions of great uncertainty and risk, EME believes the simplest and clearest incentive to encourage the connection of DG by DNOs in the short-term is a capital allowance with an appropriate rate of return. The allowance should be based on the five year spending forecasts in DG-BPQ proposals.

However, we recognise that Ofgem judge a hybrid mechanism to provide better overall incentives and we make the following observations in respect of the proposal:-

- The rate of return for DG connection and reinforcement needs to be the same as or very close to the existing capex rate of return
- The proportion of pass through needs to allow for the significant level of uncertainty in DG costs and volumes to reduce the risks to DNOs
- The size of the £/MW driver cannot be determined by reviewing the historic and interim summary data for each DNO. The most suitable size of the £/MW driver is dependent upon the penetration, technology and network availability of each DNO's network. There is no sufficiently accurate data available to determine such a figure.

### **Generator Network Availability Rebate**

A fixed £/MW rebate to generators for network unavailability would increase substantially the complexity of any incentive mechanism and so detract from the aims of clarity and simplicity.

It would also effectively increase risks for DNOs, risks which should be rewarded with appropriate returns.

We also believe that introducing an incentive such as this for DG only is likely to cause resentment amongst demand consumers who enjoy no equivalent benefit.

In addition, with the advent of large numbers of very small generators this rebate would become increasingly difficult to manage, control and administer.

### **Ofgem's Further Thoughts – Incentives For Demand Connections**

Paragraph 5.19, posed the question that, once the mechanism for the connection of DG has been established, would it be beneficial to consider the same type of incentive mechanism for demand customers?

Although we understand this is only a consideration by Ofgem at the present time, it is worth noting that this would have two major effects.

Firstly, it would require a fundamental change in the legal relationship between DNOs and consumers.

Secondly, it would radically alter the risks faced by DNOs.

Our initial thoughts are that such a measure is unnecessary and impractical.

### **Registered Power Zones and Innovation Funding**

As said previously, EME believe IFI and RPZ's could become an excellent platform for innovative growth within the industry. However, the mechanism is considerably complex and unlikely to encourage widespread take up, especially the mechanism for Registered Power Zones.

This mechanism is most likely to work if it provides unequivocal incentives to DNOs to put in the time and effort to make them work. At the moment incentives are pulling in separate directions.

Our main concerns are IIP and GoS penalties, which are still applicable while a trial is ongoing. If a DNO looks to set up a power zone, then it must consider not only the benefits from the RPZ, but also the risks associated with non-DG-related penalties. Whilst we understand the need to protect consumers' interests, and are even prepared to pay the usual GoS payments, we believe RPZs would be more attractive if GoS and IIP targets were set aside or "quarantined" for such trial areas.

At the present time EME do not believe category C projects will be supported by DNOs in great numbers. Our judgement is that, in general, the financial and resourcing commitments required to support such activity outweigh the possible benefits.

## **Assessing Costs**

### **Views invited**

6.34. Views are invited on any issues in this Chapter and in particular on:

- *the issues involved in normalising DNOs costs;*
- *Ofgem's approach to benchmarking including the issues set out in paragraph 6.27 and those raised in CEPA's report;*
- *the effect of mergers on the cost assessment work; and*
- *the use of total factor productivity estimates.*

### **Costs Normalisation**

Ofgem must ensure that as part of the process of normalising expenditure for atypical costs and credits, the following items are considered:

- Levels of insurance and associated risks – there needs to be some recognition, within operating costs, of storm costs every year. At a minimum these should reflect the cost of insurance excesses and premiums, or an appropriate allowance to normalise different levels of insurance carried by DNOs.
- Unusually low or high levels of cost

It is important that atypical costs and provision on a cash basis are not double-counted, when they are removed from operating costs.

When normalising data there are three levels of adjustments that may be required:

- Normalising costs between DNOs within the base year(s)
- Normalising for expected increase or decreases in costs over time – which should also be shown in the forecast BPQs and not double-counted
- Adjustments for Total Factor Productivity which must be distinguished from the above adjustments and not double counted

### **Benchmarking and the CEPA Report**

Our comments on the CEPA report and on benchmarking in general are given more fully in a separate response. The key points we would like to make here are:

- We welcome Ofgem's intention to use a variety of analytical techniques.
- The techniques used should be statistically robust, with statistically significant levels of confidence, to avoid creating and exploiting spurious differences in companies' data.
- We welcome Ofgem's acknowledgement that the use of the various techniques will require pragmatism and judgement.
- We especially welcome Ofgem's commitment to keeping the process fully transparent.

### **The Effect of Mergers**

Certainly for this review, we believe that the various kinds of comparative analysis employed in the benchmarking and assessment of costs need to be applied, as best as possible, to DNOs in both their merged and individual states. The impacts of mergers will only become apparent over time and, as for all business improvements, they should not be "foreseen" before they are delivered.

## **TFP Estimates**

We believe total factor productivity (TFP) analysis is a worthwhile development. Past analysis and assessments of efficiency have been conducted almost exclusively on operating costs, and we believe that this effectively means Ofgem have only ever had a partial view of DNOs' efficiency. Indeed, we contend that past, so-called "frontier" companies have gained their position by adopting aggressive capitalisation or deferral policies, effectively offering up unsustainable models of cost for emulation.

There will undoubtedly be difficulties with TFP analysis in the short-term, particularly regarding the capture of robust capital measures and the inherent lumpiness of capital. However, we believe some insight into total cost is necessary, particularly given the significant range of capitalisation policies undertaken by DNOs, and, in the long-term, we believe this could prove to be a valuable tool for both Ofgem and DNOs.

## **Overview of Benchmarking**

Comparison of DNOs' costs is meaningless at a detailed level, e.g. comparing IT costs, staff costs etc. Comparisons should be at the highest level only.

In general, we do have concerns with the robustness of each of the analytical techniques Ofgem proposes to use, especially if any one of them were to be used on its own.

We believe each of the techniques will be able to support a number of alternative, but equally robust hypotheses about DNOs' costs.

We wish to work with Ofgem to ensure that fair and reasonable comparisons are made and that any firm offered up as a "frontier firm" has total costs which are sustainable and so are worthy of emulation.

## ***Treatment of pension costs***

### ***7.31. Views are invited on the revised guidelines.***

We welcome Ofgem's decision to recognise that the current pension deficits were not anticipated in the DR3 settlements and are therefore to be given more consideration in DR4.

#### **Retrospection**

We agree with Ofgem that the treatment of pensions has been unclear in previous price control reviews and now is an opportunity to establish a fresh starting point, which will clarify the approach to pensions costs for this and future reviews.

We do not believe that consideration of future pension liabilities breaks any general rule with retrospection, as these current liabilities are clearly to be borne on the back of current and future employees however the liability arose. We are looking for customers to fund the costs of deficits at this review because they have benefited from past surpluses in DPCR3 and will again in the future, once the Pension schemes return to surplus.

It would be hard for Ofgem to maintain that mismatching equity investment, the main cause of the anticipated deficit, is inefficient or inappropriate when the pension funds of so many other commercial organisations are similarly invested. Ofgem should not encourage DNOs to avoid the risks of equity investments in pension funds, as a lower risk, bond-based strategy would put up cost considerably in the future.

#### **Protected Persons Regulations**

We welcome Ofgem's recognition of the obligations placed on the DNOs through the Protected Persons Regulations.

#### **Under-funding**

We await the detailed methodology statement in December. We believe the Pension scheme deficit, which has been certified by our scheme actuaries, should be recovered in full over the remaining working life of our employees.

#### **Regulated – Unregulated Split**

We do not foresee any issue of distribution businesses subsidising supply businesses. EME ensures that no cross subsidy is created between the distribution and other businesses by charging the same rates of employers' pension contributions with respect to all employees regardless of the business they work for.

To distinguish between companies that sold or did not sell unregulated businesses does not focus on the key issue. Distribution licence holders need to be able to fund the liabilities that they have in practice, not those that may have occurred with the benefit of hindsight. Those DNOs that transferred away the past service liabilities for active members of their supply business may have made that transfer on terms that today would look favourable. This does not imply other decisions were poor or inefficient.

The vast majority (90%) of EME's pension deficits are associated with current pensioners who worked in the regulated business.

#### **Enhanced benefits**

We continue to believe that enhanced benefits costs should be allowed in setting future price controls. These are legitimate costs that have released savings to customers through lower salary costs. We welcome the comment (paragraph 7.29) that redundancies occurring prior to March 2003 will be taken into account but believe this also should continue in the future.

We disagree with paragraph 7.28 that *'Companies would not expect to surrender to customers the benefit of achieving a given level of savings at a lower cost than they had assumed in reaching their decision to proceed.'* Any lower cost – from any initiative – gets captured at the Price Control Review process. We expect customers to share in the enhanced benefits released from our operating cost savings.

Furthermore, we maintain these so-called “enhancements” are actually rights and we are obliged to recognise them. While we acknowledge Ofgem’s points on good and bad decision-making, the simple fact remains, as stated in paragraph 7.25, that we “were not in a strong position to control the costs of benefit enhancement.” The cost of releasing staff is effectively fixed to companies, but customers will get the benefits through subsequent price controls. DPCR3 was settled on the basis that such pension costs from redundancy programmes would be covered by contribution rates and surpluses at that time. Neither companies nor Ofgem foresaw the impact of falling stock prices and lengthening lives on pension costs. In competitive markets such obligations must, in the end, be passed on to customers.

We must stress that, in the normal course of events, whenever funds are judged sufficient, using surplus to offset early retirement deficiency costs (ERDC) is appropriate. Whether the DNO makes additional contributions to the pension fund or uses surpluses to fund ERDCs should not change the impact on the customer, as this is only a short-term timing and funding difference to achieve the same result.

The DPCR3 regulatory process did not allow companies income to cover full pension contributions. Discussions on rates of contribution actually paid by companies are therefore of second order.

In paragraph 7.28 Ofgem states that companies would not expect to surrender to customers the benefit of achieving a given level of savings at a lower cost than they had assumed in reaching their decision to proceed. This is clearly not true as a regulatory framework considers actual past costs in setting future operating cost allowances. The customer therefore gains the entire benefit of decisions that turn out better than anticipated. It would be equitable for them also to share in good decisions that turn out worse than anticipated.

On the issue of deficit recovery, in paragraph 7.30, we would like Ofgem to make clear the meaning of “stronger companies” and “longer periods”. The financial strength of the parent company should not impact negatively on Ofgem’s decision to fund pension liabilities.

Any consideration of recovery periods greater than the average service life of the active membership would not be prudent. The period over which scheme deficits are recovered should be based on scheme actuary advice. Usually deficits are funded over the remaining working life of current employees, as it is only when these retire that the full liability crystallizes. This is a maximum period but could be shorter. The assumption should be the same for all DNOs.



**Additional Note - Tax**

Ofgem has recognised that changes in the tax regime mean that the tax liabilities companies are expected to incur are likely to increase in the future.

With effect from 1 April 2005 the industry will suffer a significant increase in its tax burden due to the change in treatment of deferred revenue expenditure announced by the Inland Revenue in June 2001. However, it should be noted that this is not the only change that could affect the industry. The Inland Revenue is currently considering various proposals for the reform of the corporation tax system. One of the potential reforms is the replacement of the current system of capital allowances for capital expenditure with tax relief for depreciation. This would have the effect of further increasing tax liabilities for distribution companies.