Summary of responses

Electricity Distribution Price Control Review – Update

October 2003

This Appendix sets out a detailed summary of responses to the October document.

Respondents to the October consultation document

DNOs

1. Aquila Networks plc
2. CE Electric UK
3. EDF Energy plc
4. EME Distribution plc
5. Scottish Power
6. Scottish & Southern Energy plc
7. United Utilities PLC
8. Western Power Distribution

Others

1. British Hydropower Association
2. British Gas Trading
3. British Wind Energy Association
4. Council for National Parks
5. Corporation of London
6. energywatch
7. Friends of the Lake District
8. Mowlem Energy Ltd
9. McNicholas (Power Division)
10. National Grid Transco
11. Power on Connections
12. Prospect
13. REVOLT (Mike O'Carroll)
14. Utility Partnership Ltd

Policy issues

Statutory duties

Two respondents welcomed the reference to Ofgem's environmental duties under the Environment Act and CROW Act, but they would like to hear how Ofgem intends to fulfil its responsibility under these Acts. One of these respondent said that it recognises that Ofgem's principal duty is to protect the interests of consumers but that the emerging survey highlights that those consumers' concerns embrace a range of environmental concerns.

Time table and consultation process

One DNO argued that given the tight timetable, Ofgem should confirm its policy on depreciation, metering price controls, methodology to determine operating cost allowances, cost of capital methodology and fixed retention formula for opex and capex and the proposed hybrid mechanism for remunerating DG related investment in its December document. It is concerned that delaying policy decisions until the March policy paper will result in a rushed implementation of the price control, which has been a failing in previous price reviews.

Another DNO was disappointed that main data gathering is taking place in advance of policy making, e.g. metering separation. Where companies' policy assumptions behind FBPQ are different from final policy, Ofgem should acknowledge potential rework of the plans submitted by the companies.

There was also concern that DTI involvement (i.e. Government policy requirements in relation to social and environmental objectives) is not clear from the Ofgem timetable. It was argued that especially in relation to DG (i.e. what contributions of DNOs to the achievement of renewable energy and CHP targets are expected) and network resilience (network performance standards expected by society) this is an issue.

Form and structure of the price control

Three respondents stated their support for the continuance of an RPI-X incentive regime. One respondent stated that it anticipated the RPI-X regime will be supplemented with additional incentive terms. Another respondent noted that RPI-X had delivered reduced costs, continued investment and quality improvements.

One respondent considered that RPI-X ought not to discourage necessary long-term investment in network and amenity works, while another considered that the formula was unsustainable in the long-term and urged Ofgem to consider alternative methods of incentive regulation after the April 2005 price control.

Pass-through costs

Responses from five DNOs agreed that NGC exit charges and business rates are predominantly outside of their control and so should continue to be given full cost pass-through, while two other responses indicated that these charges could be subject to a limited incentive, to ensure they are at an economically efficient level. Two DNO responses and one other response agreed that DNOs cannot materially influence licence fees, so these should continue to be given full cost pass-through.

Two DNOs noted that electricity imported from other distribution networks should be treated in the same manner as NGC exit charges, to avoid distorted investment decisions. One other DNO supported the treatment of wheeling charges as a cost pass-through and claimed that there is currently no mechanism for the recovery of these charges, so Ofgem should consider allowing recovery of these costs in the current price control period.

Two DNOs welcomed the statement that if the actual business rates are materially different from the projected rates under the current price control, Ofgem will adjust the price control revenue.

Other – Scope

Four respondents considered that the principles for connections in the gas industry should be applied to the electricity connections market. Principally, point of connection applications, design approval and inspection & monitoring charges should not be

recovered directly by DNOs, shallow reinforcement policy should be applied in regards reinforcements, deep reinforcement costs should be recovered through DUoS, the 25% rule should be abolished and Tariff Support Charges and O&M charges in the new connections market should be changed. These respondents claimed that diversions, particularly those associated with a new connection, could very easily become contestable.

One respondent considered that electricity delivered to embedded networks should be categorised as an excluded service, since the volumes and associated costs are difficult to forecast.

Fixed retention period for efficiency savings for this price control period

Two respondents supported the move to rolling retention periods for both opex and capex, but one other respondent was concerned that the rewards for opex savings were considerably greater then those for capex savings of a similar magnitude and suggested that a more equitable mechanism was required. Two DNOs asked for clarification on how Ofgem intends to assess whether a company has met its security of supply and quality obligations, and another respondent stated that the mechanism employed should be open to public scrutiny to ensure fairness of application and support transparency within the process. One respondent considered that the criteria used in the assessment should include a measure of compliance with environmental duties, and another considered that efficiency gains should be subject to verification through audit. One DNO stated that the rolling RAV benefits should be applied unless Ofgem can demonstrate a failure by a DNO to meet its obligations. Two respondents commented that the level of benefit sharing between customers and DNOs should be adjusted in line with a discussion paper from the Electricity Association.

One respondent proposed that the test for eligibility to the five year capex incentives should be extended to eligibility to the opex incentives.

Rolling opex adjustment

Two respondents expressed their support for the rolling opex incentive. One respondent requested clarification as to the definition of opex to be used and two others questioned how the proposed Ofgem mechanism would account for inflation. Five DNOs stated their support for a rolling incentive mechanism in line with Ofwat's June 2003 proposals, although two of these five were against the use of multipliers at this stage, on the grounds of data incompatibilities. One of the respondents against the use of multipliers also cautioned that the incentive properties of rewards for frontier companies may encourage short-termism of behaviour in order to secure these rewards. Two of the five DNOs favouring an Ofwat-style rolling incentive mechanism stated that it should be coded into the Licence so as to avoid ambiguity.

Two respondents welcomed the commitment that the opex incentive would not be negative for the 2005-2010 period and that underspends can be used to offset overspends. One of these requested that Ofgem declare its intentions for future periods. One respondent considered it unreasonable that companies could not get a positive allowance in respect of 2000-03, but could get a negative allowance.

One respondent welcomed the confirmation that the fixed retention period for opex efficiencies would not apply to savings achieved before 1 April 2003, but another respondent considered that it would be reasonable to include earlier years in the mechanism.

Rolling capex adjustment

One respondent welcomed the confirmation that rolling adjustment for capex efficiencies will allow companies to retain both the depreciation and the return benefits of savings, but another expressed disappointment that Ofgem appear to have settled on such a mechanism, without mentioning other proposed alternatives. Two respondents expressed concerns with the treatment of capex overspends and one of these stated that capital spend should not be disaggregated when being reviewed against the capital allowance. It also questioned the exclusion of metering capex from this period's rolling capex adjustment. One other respondent requested clarification of the mechanics of the capex adjustment, suggesting that a worked example would be helpful.

Three respondents considered that Ofgem should introduce some formal mechanism for accommodating uncertainty, with two of these suggesting interim determinations and logging-up mechanisms as being suitable for this purpose. One respondent considered that in view of the uncertainties on how capex overspends would be dealt with and the levels of network investment that may be required n the next period, a less incentivised form of regulation would be in the best interests of customers. Another respondent thought that it could be useful to extend the period over which the capex incentive is to be passed back to DNOs from five years to ten, while keeping the NPV of the incentive constant.

Distribution losses

Three respondents commented on the balance of costs incurred in reducing losses and the corresponding incentives. One of these stated that customer cost increases should not exceed the value of the reduction in losses but noted that the current scheme doesn't have a cap on cost increases. Another of these respondents noted the interaction with incentives not to spend under the rolling capex adjustment. Two respondents considered that there should be more work on reducing non-technical losses, while another respondent stated that this revenue protection function should be normal commercial practice and not subject to incentivisation.

One respondent considered that the DG losses adjustment should remain in its current form, while two respondents favoured it review or removal. One respondent was concerned that DG would increase losses, and that there should be a means of offsetting such losses so that the DNO is not unfairly penalised. Another respondent proposed marginal zonal losses charging as a means of overcoming such concerns, and also considered that if DNOs are to be protected from increased losses, they should not be able to receive the full losses incentives from increased levels of DG. One respondent was concerned that under a shallower charging regime, DNOs might choose not to reinforce and this would have an adverse impact on generator revenues. It considered that DNOs should have incentives to minimise losses from DG as well as from loads.

Three DNOs commented that work on incentives had not progressed at a sufficient pace and two requested clarification on a number of issues. Another two respondents considered that there was a need to review the methodologies used to calculate losses.

Two respondents favoured the development of losses benchmarks based on comparisons of DNO performance, while one was opposed to the use of external losses benchmarks for each area. A respondent in favour of benchmarking considered that there should be an incremental increase in the benchmark to incentivise improvements rather than a stagnant level of losses.

Other issues

One respondent asked for confirmation of their understanding that the rateable liability for metering assets will be reallocated to the network assets, and noted that there needs to be consistency in the transmission and distribution charging arrangements in England & Wales versus Scotland in order to avoid inefficient locational signals.

Quality of Service and other outputs

Customer Survey

Those that responded broadly agreed with the first stage of the customer survey and Ofgem's approach to assessing willingness to pay. However a number of interested parties felt there was a misrepresentation in the October paper about consumers' willingness to pay for under-grounding of the network and that given the strong consumer support; this issue should feature more predominantly in the second stage of the survey. Similarly it was highlighted that environmental improvements are a public good and some account needed to be taken of customers' desire for, as well as, willingness to pay for improvements.

One DNO highlighted that only 4 per cent of those surveyed were willing to pay for improvements and argued that the views of a minority should not inappropriately influence overall policy. The consensus was that there was there was not a high level of willingness to pay reflected in the survey and that comments were generally positive about retaining the status quo and as a result there were concerns about enhancing quality of supply targets.

Over half the DNOs were concerned that first stage of the customer survey did not accurately reflect the significant associated costs that would be required to put the proposed standards and schemes in place. As a result it was considered inappropriate to

focus purely on the initial findings and that the second stage of the survey needed to accurately reflect the realistic financial trade offs to customers and the marginal cost benefit structure in order to obtain robust results.

Network Resilience

There was broad agreement amongst all interested parties that network resilience is a key issue and welcomed a move towards a longer-term view on network management. Many parties showed continued support for the Network Resilience Working Group recommendations. DNOs generally had a strong view that it is difficult to define resilience on an equitable basis as it cannot be predetermined what an efficient response may be due to the variability between networks and different events and can only be truly measured during an exceptional event. DNOs generally do not support an outcome based incentive scheme specific to this issue because it is believed that any such scheme is likely to be arbitrary. One DNO positively supported an incentive mechanism relating to a DNOs response to an exceptional event, as they felt this was within the control of the DNOs. Two DNOs specifically mentioned an input based incentive scheme, such as tree cutting and long-term investment, to address the underlying issue of network resilience. It was argued that this would be more practical to administer. Others noted that this is already incentivised through the interim arrangements recently introduced. A number of respondents suggested any decision should be based around a willingness to pay approach.

Two DNOs identified that using a benchmarking or comparative measure would be simplify the issue too greatly and would introduce perverse incentive for DNOs not to share resources.

One respondent highlighted that there was no incentive to invest in under grounding as long as the DNOs' performance was not poor by comparison to their peers.

Changes to Standards of Performance

There was broad agreement that there is no need to tighten the guaranteed or overall standards of performance framework (GOSPs) and that the current IIP framework should remain intact while supporting longer-term targets. Three DNOs identified that any tightening of the standards would require additional funding and cost allowances, whilst

many DNOs expressed that any changes should be based on consumers willingness to pay. One DNO noted that the majority of customers expressed no willingness to pay for tighter standards.

The focus of responses taking the standards of performance forward was split between increasing awareness of the standards and strong support around increasing the robustness of the present system. One respondent identified that any expansion of the GOSPs framework must have the same robust standards of reporting as the present scheme set out in the RIGs.

Three respondents commented on automatic payments. It was noted from the customer survey that customers are not willing to pay the associated costs of full phase connectivity that is required for automatic payments, although it was noted that DNOs could be more proactive about informing customers about their entitlement to claim. One of the respondents felt the DNOs should make automatic payments.

A large number of respondents supported the Priority Service Register (PSR) and the introduction of a dedicated helpline. It was argued that this would require a tighter definition of a priority customer to ensure it was an effective system and cost efficient to introduce. The definition of business customers also needs to be tighter if similar arrangements are to be made for them.

In response to the findings of the customer survey, four DNOs considered that compensating business customers for consequential loss was inappropriate and did not reflect their willingness to pay. It was suggested that this arrangement is available in the insurance market and it is this source that customers should be drawing on. A similar argument was applied to the provision of back up generators.

Scope of the outputs incentive scheme

Of those that supported incentivisation of resilience, they felt it should be undertaken outside the scope of IIP, and possibly within the RPI-X formula. There was one notable exception, who pointed out that most of the measures proposed for measuring responses to exceptional events were already audited under IIP.

One respondent highlighted that if the DNOs converge in their performance levels under the customer survey and proposed speed of response criteria, the results could

become highly volatile, affecting investment decisions. In addition this may encourage inefficient investment where there is not the willingness to pay for the improvements.

Three DNOs commented specifically upon multiple interruptions and felt it would require additional investment and were not supportive of including it under IIP arrangements.

One respondent felt that there was further scope to measure environmental outputs such as amenity works and under grounding of cable particularly in designated areas.

One respondent suggested increasing the scope of the output measures to include worst served customers, which would go some way towards addressing the urban/rural service discrepancy, as well as the average customer.

Comparing Quality of Supply performance

There was broad consistency in the concerns expressed by the respondents on this issue. These included concerns that benchmarks were unrealistic because they were based on one year's performance, that they do not take into account differences in network makeup and that the performance could be achieved under differing conditions. One respondent noted that the benchmarking year was an atypical year because of benign weather.

There were conflicting views that disaggregation was a robust basis for making comparisons and setting consistent targets. Those respondents that were supportive noted however that this did not mean the targets will be equally challenging as they will depend on individual operating costs and capital expenditure. As a result a number of DNOs stated that it is only suitable for relative performance measures. One DNO pointed to additional research that suggested that the model used only accounted for 25 per cent of the network variability observed.

Two DNOs felt that the disaggregation process is to highlight why each DNO performs differently. This information should not be used in isolation, but together with the associated costs of improvement and willingness to pay information as the criteria for target setting. One DNO maintained that the lack of explanatory proof means they cannot be used to set robust targets and echoed the thoughts of other DNO taking this forward.

One DNO observed that the data sets used lacked common definitions, causing errors in comparisons and therefore data would need auditing before benchmarks could be used. One DNO felt that the starting points for setting targets were not realistic as a result of inconsistent data sets being used for the benchmarking and the setting the targets. This applied at both HV and EHV.

A DNO expressed concern that due to normal weather variations, DNOs may be at risk of not meeting their spot targets.

With regard to the longer-term targets, respondents were supportive of the approach outlined, subject to the concerns around benchmarking, but that they should be judged against customers willingness to pay and the societal view. One respondent noted that the 2020 target appears unchallenging in the light of the improvements under the IIP incentives scheme.

Two DNOs maintained that exceptional events should be taken into account when assessing and comparing performance and the targets adjusted accordingly against the glidepath.

One DNO noted that they felt it was inappropriate that networks with different inherent characteristics be compared. Another noted that if the interim arrangements are to continue, they would argue for a reduction in the 2 per cent revenue exposure.

Frontier Performance

A couple of respondents argued that frontier performance should be based upon the DNOs own rate of performance as the normalised performance is not robust. One DNO expressed concern that Ofgem will use quality frontiers without proof of calculation comparisons. Another expressed concern that frontier performers do not necessarily achieve frontier performance under every operational condition. One interested party felt that absolute better performing companies should be better rewarded than poorer performing ones.

One DNO noted that frontier performers will have access to rewards irrespective of whether they meet their 2004/05 target, but that DNO that deliver the same frontier performance will receive materially different rewards. As such they feel all frontier performers should receive the full out-performance reward.

There was confusion about whether the 'frontier performance' ran alongside IIP or as a replacement to it. If it ran along side, this goes against the initial scheme that they signed up to. Another respondent who was unhappy that DNOs which signed up to the process are now claiming it to be inequitable and are supportive of ex post adjustments.

Distributed Generation

DNO information on DG volume & costs

Most of the DNOs who commented saw that the data demonstrated significant variation and uncertainty in DG growth and associated network costs. One DNO questioned whether all DNOs had made consistent underlying assumptions regarding the government targets.

In addition to the DNOs, one respondent encouraged Ofgem to make further publication of data and analysis in the future. Another one pointed out that DNOs' forecasts need independent verification and, where possible, benchmarking on individual components.

Incentive framework

Respondents commented on various aspects of the proposed hybrid mechanism.

On the general framework, the majority of the comments were in broad support of the proposed hybrid mechanism framework. Most of the others found the mechanism suitable for application on at least some of the costs relating to DG. Three of the eight DNO respondents expressed preferences for different arrangements: two preferred an arrangement based on using forecast to set allowed revenue, at least for a "baseline" level of DG-related costs; the other preferred the use of £/MW driver(s) together with a logging-up mechanism. Two respondents pointed out that the framework should treat all DG consistently regardless of their sizes and technologies, whereas another argued for incentives only to be applied to high quality CHP and renewable generation plant.

Only the DNO respondents commented on the proportion of costs that should be passed through. Most of them believed that it should be equal or close to 100%, at least for cost elements not controllable by DNOs. Some also cited the power given by the

Electricity Act for the DNOs to recover connection costs as a support for a high pass-through rate. Two DNOs argued for the passed-through costs to be given the regulated rate of return, with one of them arguing for single RAB treatment to demand and generation related capex. Another believed that the return to the DNOs' investment relating to DG should be about twice the current weighted average cost of capital. One DNO further argued strongly for the DNOs to have the option to re-open the price control when costs exceed significantly the income allowed under the incentive framework.

The respondents considered that the £/MW incentive, as a supplement to the pass-through, had a useful role in encouraging the DNOs to effectively facilitate DG or to provide a premium return to cover other costs and uncertainties. Two DNOs believed that it would be disproportionately complex to develop multiple £/MW for different voltage levels or generation technology types. However, one pointed out that a single formula for all DNOs would be unsuitable, and cautioned against calculating the incentive rate(s) based on historical and interim data.

On the incentive for DNOs to provide network access to DG on an ongoing basis, one respondent strongly supported the induction of payment for unavailability of network access yet was concerned that the DNOs may delay the connection till reinforcement was completed. Two DNOs opposed the payment scheme due to increased complexity and risks to DNOs and the potential dissatisfaction of the demand customers. One preferred an alternative scheme based on the MWh availability agreed between the DNO and DG. Other DNOs commented on issues that such a scheme needed to resolve, including: alignment with treatment in demand, clear exclusion of low-cost connections chosen by DG, and making allowance in price control for increased costs for the DNOs.

None of the responses received (all from DNOs) were supportive of applying the DG arrangements to demand customers. The reasons given against developing similar arrangements for demand included: the need to gain sufficient experience of the DG arrangement, unjustified level of complexity, the remaining uncertainty regarding connection charging boundary, and increased regulatory intervention & uncertainty.

Innovation Funding Incentive (IFI)

Only one respondent expressed serious concerns about the incentive. The key issues that respondents commented on included:

- the need for a simpler approach;
- the appropriate pass-through rate for innovation funding; and
- the range of activities that would qualify.

Several respondents argued for a simpler mechanism. Only one respondent positively supported Ofgem's proposal to have three categories of R&D activities.

Ofgem initially suggested that the pass-through rate should be in the range 50-75% for categories A and B and 0% for category C. Several respondents argued that 100% pass-through should be allowed to encourage DNOs to positively engage in new R&D and to justify the sharing of the outputs from this work.

There was also a strong view that category C activities should be fully integrated into the IFI and allowed pass-through funding.

Registered Power Zones (RPZ)

A simpler mechanism was argued for with fewer restrictions; for example, the 50MW limit is seen as unhelpful.

One respondent argued that all innovative projects should be rewarded and that incremental improvements should be incentivised as well as discrete schemes. Concerns also remain about the potential impact of having to meet IIP and Guaranteed Standards in RPZs. One respondent suggested that the BSC and ER P2/5 could be relaxed in an RPZ.

Several DNOs indicated that they were already evaluating potential RPZ projects both on a generic and site specific level. Finally, one respondent commented that, while supporting RPZs, they should not be allowed to delay connections.

Cost assessment

General approach

Respondents to Ofgem's October paper supported the use of a range of techniques for assessing costs and efficiency. Some DNOs reiterated the importance of transparency and welcomed the level of transparency shown by Ofgem to date. One DNO welcomed the commitment not to combine the approaches in an arbitrary and pre determined manner but felt this was weakened by Ofgem's need to exercise a degree of pragmatism. Another DNO welcomed Ofgem's commitment to judgement, pragmatism and transparency.

Information disclosure

One supplier responded that the data published was inadequate for it to assess its future DNO costs and also that also that the data revealed some trends which would require further investigation. This supplier also had concerns that DNOs were sharing information among themselves which was not in the public domain.

One DNO thought that the financial information published was misleading as it had not been audited or standardised. They suggested that only standardised data be published.

Forecast Business Plan Questionnaire (FBPQ)

One respondent commented that loss reduction scenarios should have been included in the FBPQs. A DNO stated that the level of detail required in the FBPQ was excessive. A number of DNOs said that Ofgem should put more reliance on the analysis of higher level information than in the FBPQ. The same DNO thought that the DNOs' own scenario was the most relevant compared to the base case and quality of supply scenarios which should only be used as a cross check..

Normalisation details

Most of the DNOs stressed the importance of having fully normalised data on which to base the comparative analysis. One DNO said it was important to recognise differences in accounting polices, operating environments, performance on quality and network risk profiles. Another DNO highlighted the importance of normalising for atypical costs and

capitalisation policies which it believed accounted for the majority of the variation between the DNOs. Another DNO noted that care should be taken not to double count the removal of atypical items. One DNO thought normalisation of capitalisation was not complicated as it would only involve consideration of tree cutting, faults and overheads.

Other suggested items for normalisation included insurance costs (with relation to storm costs) rural/urban customer mix, proportion of overhead lines, climate, lightning, tree coverage, engineering policies and construction standards.

Some DNOs commented on the scope of normalisation. One DNO said there were three adjustments required. Firstly, between DNOs within a base year, secondly, normalisation for activity and cost levels over time and finally adjustments for Total Factor Productivity (TFP).

Benchmarking

General

Most of the respondents who commented on benchmarking welcomed CEPA's report as an opportunity to discuss the key issues around the use of benchmarking. A number of DNOs queried the quality of data CEPA used in the analysis in the report and those DNOs suggested that as a result some of CEPA's findings would have to be treated with caution or disregarded. Many respondents stressed that having fully normalised data would be critical to achieving a robust benchmarking analysis

Benchmarking techniques

There was general support for Ofgem's intention to use a number of benchmarking techniques and benchmarking a number of cost categories. One DNO said that the greater amount of analysis may not produce unequivocal, statistically more robust findings but it would inform the discussion on cost assessment. Two DNOs were concerned that transparency might diminish if a large number of techniques were used.

Most respondents said that they supported the use of Data Envelopment Analysis (DEA) although some DNOs were not supportive. A number of DNOs stated that DEA did not offer test statistics and therefore could not pick up defects in the data it used though one

DNO said if a large amount of data was available a simulation technique called "bootstrapping" could be used to test the statistical robustness of the DEA frontier. One DNO thought that the sample was too small for regression to provide any statistical verification for DEA. One DNO said as it was possible to (hypothesis) test the error term in SFA and it would be possible to achieve robust analysis with the technique. The same DNO added that Stochastic Frontier Analysis (SFA) could be used with two or three years DNO cost data.

A number of DNOs commented on Ofgem's approach to regression analysis. In general the DNOs agreed that a statistical test should be used to select cost drivers, functional forms and overall models. One DNO said that no restriction should be placed on the intercept term. On the issue of returns to scale one DNO felt that regression Ordinary Least Squares (OLS) with scale variables should capture the effect of scale.

All of the DNOs which commented favoured using input orientated models. One DNO said that the fact that different outputs and inputs had been chosen by regulators which used DEA, demonstrated the randomness of specifying DEA models.

Frontier or average benchmark

All the DNOs favoured using an average benchmark to set efficiency targets. Many of the DNOs felt the prospect of out performing the average provided a strong incentive to improve efficiency and receive above average rates of return. In contrast the DNOs suggested that using a frontier benchmark imposed larger efficiency targets on the DNOs with little incentive to achieve them and possibly increases network risk. One DNO cited surveys of banking and farming sectors which suggested that the average firms were 80-90% behind the frontier performers. On this basis the DNOs suggested that the average benchmark approach was more consistent with the competitive market.

Cost drivers

On the subject of cost drivers many of the DNOs commented on CEPA's analysis and selection procedure. A few DNOs disputed CEPA's process for selecting cost drivers because it was done on the basis of correlation tests with other cost drivers and then regression against efficiency scores. One of the DNOs said it would have been easier and more effective to select cost drivers on the basis of univariate regressions with the cost being benchmarked. Another DNO criticised CEPA for assessing cost drivers in

isolation from the composite variable as the two together may have had greater explanatory power.

A number of DNOs criticised CEPA's decision to drop customer numbers from the composite variable on the basis of its high correlation with units distributed and some of the DNOs disagreed with CEPA's rationale that the efficacy of customer numbers was diminished by the separation of metering. One DNO cited analysis of US data that suggested that customer numbers remained a highly dominant cost driver even when customer related expenses were excluded.

One DNO suggested that the principal driver of network costs was network assets in terms of amount, nature and operating environment. This DNO thought network length was the best proxy for assets and therefore the most relevant of the variables in the composite scale variable.

Total cost analysis

A number of respondents commented on how total costs could be calculated for the purposes of benchmarking. Almost all of them agreed that the definition of capital consumption was crucial. Some DNOs criticised CEPA's use of RAV in its definition of total cost as the RAV was distorted by previous regulatory judgements. One DNO believed that the RAV would reflect the underlying asset base and could be used to develop a capital stock measure. One respondent believed RAV could be used providing common depreciation profiles were applied across the DNOs Another DNO stated it was important for any measure of total cost to reflect the different positions of the DNO in their investment cycle.

International and Panel Data

Almost all respondents who commented on the issue thought that there was insufficient time and resources to incorporate analysis of international DNOs into DPCR 4. A number of DNOs thought it would be worthwhile to work on the normalisation of such data for use in DPCR 5. Most respondents agreed that panel data would strengthen the benchmarking analysis but didn't think that reliable data could be provided for use in DPCR 4.

Inclusion of Quality of supply in benchmarking

Most of the DNOs who commented on this issue thought it was important to include quality of supply in the benchmarking analysis. These DNOs were concerned that CEPA had dismissed inclusion of quality (on the basis of significance from second stage regression against efficiency scores). Two DNOs didn't think that quality of supply should be included in the benchmarking analysis and one of the DNOs stated that costs and quality and supply should be subject to separate incentives therefore they should not be analysed together.

Total factor productivity

A number of respondents emphasised that CEPA's analysis should be interpreted carefully, particularly their choice of comparator industries and the weight placed on historical productivity trends, which would be driven by the "catch up" from privatisation and therefore unlikely to be an indication for the future. One DNO stated that it was important that the input data was robust and that the analysis took account of the economy wide performance. One DNO was critical of TFP as a measure because the DNO thought it did not account for quality and other exogenous factors such as relative efficiency.

Two DNOs welcomed the use of the TFP study, one said it was a start on total cost analysis which was necessary given the range of capitalisation policies employed by the DNOs. Another DNO said the study would be helpful in providing an estimate of a reasonable future growth rate in productivity. Two DNOs queried why future efficiency targets for the DNOs should be identified, they believed that assuming efficiency improvements as a part of the next price control would unduly increase the level of risk because there was little scope for further efficiency improvement.

Mergers

A number of respondents supported the analysis of company groups though one DNO did not think such analysis would be useful and that DNO said company groups would be marked down under DEA. Another DNO thought it would make no difference as all DNOs were part of wider corporate groups. Two DNOs expressed concerns that the comparative analysis may discriminate in favour of merged DNOs and said that merger

savings could be achieved in both opex and capex. One respondent suggested that comparability between DNOs could be achieved by adding £12.5 million to the opex of each DNO in the benchmarking.

A number of respondents commented on the interaction between Ofgem's policy on merger savings and its approach to benchmarking in DPCR 4. One respondent felt that Ofgem may have to revise its merger policy to be consistent with its approach on benchmarking. Two DNOs stated that applying separate revenue reductions and determining the DNOs efficiency through comparative analysis would "double count" merger savings.

Pension Costs

General

Most respondents have welcomed Ofgem looking at the pensions issue at an early stage of the review. A number of respondents agree that the guidelines are appropriate for the future. One respondent recognised that Ofgem is not attempting to affect the legal rights and duties of employers or pension scheme members but they say that is not the point. In their view distributors had legal obligations which meant that they could never achieve the competitive level of costs referred to in Ofgem's June 2003 paper. Another respondent also welcomed Ofgem's recognition of the obligations placed on the DNOs through the protected persons regulations.

One DNO mentioned that the deficits would disappear if the stock market recovered. This respondent also said that pension costs should be treated as a pass through cost.

One respondent argued that pension costs should be treated as any other controllable operating cost. Therefore companies should be rewarded for out performance and penalised for under performance and pension costs should be benchmarked.

A number of respondents would prefer pension deficits or surpluses to be spread over a period not greater than the average remaining working life of active members of the relevant pension scheme and that stronger companies should not be treated differently.

One respondent has also mentioned in a separate document that they sent to Ofgem, a way forward that involved setting up sub-accounts for the price controlled businesses in

the pension schemes. This would have a start date of 31 March 2001 and use data from the last actuarial valuation of the ESPS.

Retrospection

The majority of respondents said that Ofgem's policy was in places retrospective and one DNO said that a certain amount of retrospection is unavoidable.

A number of respondents said the treatment of pension costs in past price controls has been unclear and a fresh starting point is required to clarify the approach to be taken in respect of the present price and future price controls.

One DNO said it is questionable whether the funding of current pension scheme deficits represents the retrospective adjustment of past costs since the market movements that caused the deficits are very recent.

Price controlled/non price controlled split

A number of DNOs said that all pension liabilities that arise from the discharge of the statutory duties of area boards or their successors should be recovered from distribution customers. One DNO said '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'.

One DNO agrees with Ofgem that only the pension costs of the distribution business (including metering) should be funded and thinks that sufficient data is available to perform a reasonable split between the price controlled and non-price controlled business.

One DNO said that they agree that a clear starting position must be established and that some retrospection will be required. In addition they fully supported Ofgem's aims of providing an equitable basis for sharing increased costs between customers and shareholders and providing clarity for the future.

Another respondent said that for some businesses in considering the price controlled/non-price controlled split a large amount of estimation will have to be used. This is particularly the case where prior to separation different regulated business

activities were carried out within a single legal entity. One DNO also said that the current definition of the distribution business should not be used to determine the split.

One respondent representing a number of DNOs indicated that they accept that there should be a split from the date of the transfer scheme (1 October 2001) but they also say that the distribution business should include all of the accrued liabilities in respect of all the former employees of the distributor's predecessor up to 30 September 2001.

On the subject of asset allocation one DNO said that the regulated/unregulated split should consider the obligations of the scheme to its different classes of member and the assets it holds with respect to those different classes of member.

A number of respondents said that it is normal in commercial transactions where a business rather than a legal entity is sold the pension obligations of past employees of the part of the business being sold remain with the incumbent business.

One DNO finds the argument that non-ex-PES suppliers have substantial legacy pension liabilities to be unpersuasive. This respondent said that 'companies which took over supply businesses after privatisation had the opportunity to negotiate an appropriate balance of pension liabilities, assets and purchase price.' The respondent also disagrees with Ofgem that companies who sold their supply business would have retained the full benefit if the value of the pension liabilities had decreased. The respondent said 'this reasoning is flawed. Once the distributors had sold off their supply business they would have expected their future revenues to cover their costs, including the cost of historic pension liabilities, whether those costs rose or fell.'

Past under/over funding

A number of respondents said that allowances at the last price control were not determined solely on actual costs and hence this complicates any solution which assumes that the accounting charge depicts amounts allowed. A number of respondents said that Ofgem should not be retrospective here as there was no certainty over what was agreed at past price controls. One DNO said it is difficult to determine both in principle and in practice and another DNO said Ofgem had not typically made available the detailed assumptions underlying its past price control calculations.

A number of DNOs said Ofgem is incorrect to say that previous price controls were based on efficient accounting charges because operating cost allowances at the last review were based on standard controllable costs of the frontier companies.

One respondent argued that the main anticipated deficit is due to mismatching equity investment and that Ofgem cannot argue that the practice is inefficient as many other commercial organisations have invested in a similar manner. The respondent also said that the adoption of a lower risk bond strategy will result in considerably higher pension costs in the future.

Another respondent argued that companies have used different investment strategies in funding pensions. Therefore deficits should only be passed on to customers if it is demonstrated that customers benefited when schemes were in surplus.

The use of pension fund surpluses to fund severance programmes

Some respondents argued that so called 'benefit enhancements' flow from legal obligations that DNOs (and their predecessors) have to both employees and former employees and cannot be avoided, as such these costs must be allowed in full in the price control.

The majority of respondents argued that whilst they acknowledge Ofgem's need to ensure that DNOs have taken appropriate action to reduce operating costs, they are concerned that Ofgem wants to 'claw-back' to customers, expenditure that enabled savings to be made. The DNOs in particular strongly made this point. One respondent representing a number of DNOs also said that Ofgem knew that the DNOs were using the surplus to fund severances at previous price controls and that Ofgem did not take action at previous reviews about this issue.

Many respondents said that customers benefited from lower operating costs at the last price control as a result of redundancies. One respondent re-iterated that it is common business practice to fund redundancy payments from pension surpluses hence DNOs should not be penalised where they have taken this approach.

Other financial issues

Some respondents commented on other financial issues. These issues were not included in the October document and hence most respondents did not comment on them.

One respondent argued that the change in treatment of deferred revenue expenditure by the Inland Revenue, coming into effect from 1 April 2005, will significantly increase the industry's tax burden. It also argued that in addition if capital allowances are being replaced by capital expenditure with tax relief for depreciation this would further increase tax liabilities.

One DNO commented that a higher cost of capital is supported by market evidence, recent regulatory determinations and academic studies. It also argued that a pre-tax approach to the cost of capital should be maintained.

One DNO argued that given that DNOs face higher levels of investment compared with the past, they will need to attract sufficient funding to finance this investment, which in its view suggests that credit ratings will have to be comfortably within investment grade and significantly above the current minimum levels of BBB-/Baa3.

One DNO commented that a mechanism is needed to address cost uncertainty between price controls.

One respondent commented that corporate restructuring has resulted in a reduced property portfolio, with shareholders subsequently having benefited from the sale of some of these properties. It argued that these asset disposals should be taken into account in assessing the RAV so that customers can share in increased efficiency.

Regulatory Impact Assessment

The respondents who commented on the initial regulatory impact assessment included in the October document were supportive of the development of a full RIA for DG. One agreed with the costs, benefits & risks identified and believed further work would be required on assessing the impact on quality and security of supply as well as potential

distributional effects. Another one pointed out that the initial RIA indicated Ofgem's focus still being on efficiency and that the assessment should include wider social and environmental factors such as emission levels.