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11 February 2005

ELECTRICITY DISTRIBUTION – ANNUAL COST REPORTING

Introduction

During the recent electricity distribution price control, a substantial amount of work was necessary to collect and “normalise” cost data from the distribution companies. As a result, it was widely recognised that it would be more efficient and effective to collect this data on an annual basis and Ofgem committed to taking this forward.

The purpose of this letter is to explain the process Ofgem is following and to provide an indication of the information that Ofgem expects to collect and to publish, in order to invite comments from all interested parties.

Licence Obligations

As part of the licence modifications to give effect to the electricity distribution price control review, a new condition is being introduced which will require the licensee to report price control review information each year. This information mainly relates to the costs incurred in undertaking activities covered by the price controls.

This requirement is separate from (and additional to) the requirement to publish “regulatory accounts” each year. Licensees will now have to publish regulatory accounts for the year ending 31 March by 31 July each year, starting with the year ending 31 March 2005.

The regulatory accounts will largely provide the normal accounting information included in statutory accounts, prepared to 31 March in all cases, and will therefore only have minimal prescription e.g. they will include a corporate governance statement and an operating review.

The cost reporting project will be kept separate from the regulatory accounts and, unlike the accounts, will prescribe a common basis for information to be reported through a detailed reporting pack and associated instructions and guidance.

In addition, there will be separate reporting requirements for actual revenue and the other relevant variables which determine allowed revenue in accordance with the price control formula. These are subject to separate reporting instructions and guidelines.

For both costs and revenues, the appropriate totals will be reconciled to the regulatory accounts.

Project overview

Over the past few months, Ofgem has been developing a draft version of the Regulatory Reporting Pack (RRP) for annual submission of cost and related information. This has been discussed with the distribution companies, together and individually, and their comments have been very useful.

All of the licensees have agreed to complete the draft pack for the year ending 31 March 2005 by 31 July 2005. This will provide a basis for determining the Regulatory Asset Value at 31 March 2005, provide a full test of the pack and will provide comparative figures for 2005/06 – the first year of DPCR4.

Changes may then be necessary to the pack to reflect lessons learned during 2005 and it is anticipated that a revised set of instructions and templates will be consulted on and finalised by early 2006.

Distribution companies would then submit 2005/06 information in July 2006, which would be reviewed by Ofgem before the end of 2006. Changes to the instructions and templates would be made if necessary to resolve any inconsistencies remaining and the process continue for 2006/07 data in 2007 and so on.

Ofgem intends to visit all DNOs annually using the RRP as the basis for discussing and understanding DNOs performance, the impact of any organisational changes and any changes in accounting treatments.

Purpose of RRP

The purpose of the RRP is two fold:

- ◆ firstly, to allow Ofgem to monitor actual costs incurred by DNOs against those assumed in calculating allowed revenues (as set out in Ofgem's DPCR4 Final Proposals document, November 2004); and
- ◆ secondly, to inform Ofgem when the time next comes to review the price controls for electricity distribution (a project likely to be conducted during 2008 and 2009).

Ofgem has not decided how the next price review will be undertaken. In particular, no decisions have been made whether to assess costs on a more disaggregated basis. The reasons for having cost information at a more disaggregated level are that this is likely to help identify inconsistencies and that it keeps open the option of using more detailed information at the price review.

Information to be requested

The current draft templates and instructions are available on Ofgem's website, in the Distribution Price Control area of work. These tables and documents must be read in conjunction to gain a proper understanding of cost reporting requirements. The instructions set out the purpose of each table in the RRP, which costs should be included and the use Ofgem expects to make of the information.

The definitions of costs and activities included in the instructions are key to the proper completion of the RRP tables.

Part 1 of the template calculates values comparable with the assumptions underlying the DPCR4 and updates the Regulatory Asset Value.

Part 2 collects cost data in the form of a cost matrix and supporting detailed schedules. The level of cost disaggregation is driven by the need for a better understanding of cost drivers and the ongoing development of Ofgem's comparative analysis. Also Ofgem is keen to develop a common set of cost and activity definitions to minimise the scope for interpretational differences across the sector.

Ofgem is continuing to develop and refine activity headings and definitions in discussion with the DNOs. This draft contains Ofgem's most up to date view of the appropriate headings and definitions but readers should be aware that these are subject to further development and refinement.

Part 3 contains other information on asset data and debt levels to inform the next price control review.

Publication and comparability

Ofgem is committed to improving the transparency of network monopoly regulation. Publication of financial information will contribute towards this. With the exception of one DNO group, all the companies accept that annual publication of the regulatory asset value would be appropriate.

Some of the distribution companies support the publication of detailed cost information, with the exception of information that relates to contestable activities and, in some cases, some other issues such as tax. Other distribution companies are opposed to publication of more than minimal information, for example, expressing concerns about the possibility of such information being used by analysts. Almost all of the distribution companies would like to share the majority of the information among themselves.

In addition to the above issues, there is a further consideration in relation to 2004/05 data as this will have been submitted against an untested version of the pack, comparative prior-year data and regulatory allowances are generally not available on the same basis, and the calculation of the regulatory asset value is on a different basis. Some companies have argued that less information should be published in respect of 2004/05.

Ofgem intends to publish a summary of the information in late 2005, the form and content of which is yet to be decided.

Several of the distribution companies have also argued that the information collected will not be comparable across companies. Even if all differences in allocation or attribution of costs are removed there will clearly be several reasons why costs differ across companies, including:

- ◆ differing size of operations,
- ◆ regional factors,
- ◆ corporate structures,
- ◆ operational practices, and
- ◆ external events.

It is likely that costs for individual activities will be more subject to variation than costs for the licensee as a whole. Because of this, it is unlikely to be appropriate to draw conclusions from unadjusted data.

As noted above, Ofgem's view is that greater transparency would be appropriate, although there is a case for exclusion of some data where activities are competitive. Ofgem would welcome views on whether any other exclusions are appropriate (for example, due to listed company status, either in the UK, the USA or elsewhere) and on whether less information should be published in respect of 2004/05, for example for the reasons given above.

Audit/review of RRP

A variety of views have been expressed by the companies on the requirement and form of any independent audit/review of the RRP. Ofgem is considering if and how the RRP should be audited/reviewed in addition to its own annual review.

Issues for consideration are the cost versus the benefit of an independent audit/review; whether it would be more effective to have a single independent auditor/reviewer or different auditor/reviewers for each group; level of materiality and to whom audit/review opinions should be addressed.

Timetable

Ofgem intends to publish the final version of the RRP for 2004/05 data in April 2005. The results of the review of this information will be published towards the end of 2005.

Responses

Ofgem would welcome any comments on the overall direction of this project, on the form and content of the Draft RRP and Instructions and on the information which should be published.

Responses, to be received at Ofgem by 31 March 2005, should be sent to:

David Broster, Head of Distribution Finance and Regulatory Reporting.
Email address: david.broster@ofgem.gov.uk

Any questions should, in the first instance, be directed to David Broster (telephone: 02079017341).

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