



Your ref

Our ref

Paul O'Donovan  
Manager, Distribution Price Control Review  
Ofgem  
9 Millbank  
SW1P 3GE

Lloyds Court  
78 Grey Street  
Newcastle upon Tyne  
NE1 6AF  
tel (0191) 223 5115  
fax (0191) 223 5132  
e-mail:john.france@ce-electricuk.com

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Dear Paul

### **Assessment of the Electricity Distribution Price Control Review Process**

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL). The views expressed represent the response of CE, NEDL and YEDL to Ofgem's publication, '*Assessment of the Electricity Distribution Price Control Review Process March 2005 91/05*'.

Overall we believe that the review process was effective. Ofgem initiated the review with a clear set of high-level objectives at the outset and we believe it stayed true to these throughout the process. On the whole, the process has improved very considerably since DPCR3.

Our detailed response to the consultation document is attached and is in two parts. Part 1 provides the CE view of the key learning points from the price control review, whereas part 2 provides a brief response to each of the questions that are posed in the consultation document.

We remain committed to working with Ofgem with the aim of further improving the price control review process and we commend Ofgem on taking the time to consult and meet with interested parties to review the process and to identify the key learning points for next time.

Yours sincerely

**John France**  
**Director of Regulation**

**CE ELECTRIC UK FUNDING COMPANY**

Registered Office: Lloyds Court, 78 Grey Street, Newcastle upon Tyne, NE1 6AF. Registered in England: 347620

## **PART 1: CE ELECTRIC UK VIEW ON THE KEY LEARNING POINTS**

### **Timetable and process**

- 1 Ofgem should be congratulated on keeping to most of their project plan timetable deadlines. Consultation documents generally appeared when Ofgem said they would.
- 2 Ofgem conducted the review with professionalism and, generally, the workstreams and formal processes operated fairly smoothly.
- 3 We had sufficient access to senior people at Ofgem. Getting our views considered was not a problem.
- 4 However, prior to the commencement of the DNO's review, signalled by the submission of the HBPQ, Ofgem and DNOs (and other interested parties) had engaged in a year's worth of discussion of the principles that would inform DPCR4. This was useful because it is easier to conduct genuine discussions about principles before the negotiations about specific companies' cost allowances have started in earnest. We would recommend a similar approach at DPCR5.
- 5 There appeared to be insufficient time to give proper consideration to PB Power's reports on capex requirements. Indeed, it seemed as if Ofgem was quite content to work from unfinished draft reports that would not be finalised in time to have meaningful discussions.
- 6 The difference between the *Initial proposals* and the *Final proposals* was very significant. We are of course pleased about the positive movement, but it does raise the question of whether Ofgem should have got closer to the end result at the *Initial proposals* stage. Moreover, more could have been done to signal what Ofgem had in mind prior to the *Initial proposals*. This would have led to a debate that would, in turn, have led to a set of *Initial proposals* that were closer to the necessary final outcome.
- 7 Rather a lot of changes were also made between the *Update* and the *Final proposals*. This meant that some important changes were never exposed to challenge or discussion. For example, the under-grounding allowance was published without any prior discussion.

### **Cost v risk issues**

- 8 Ofgem appears to be reluctant to get deeply involved in assessing the risks being taken by companies .
- 9 For the next review Ofgem needs to recognise that *any* further change in the exposure of revenue to performance incentives must be done taking into account the risks, and therefore, the nature of the systems that Ofgem implicitly chose to fund at DPCR4.

### **Building confidence and reducing regulatory risk**

- 10 Incentives depend to some extent on the confidence that licensees can have in the degree of commitment being given by the regulator. In the closing week of the review CE (and EdF) worked with Ofgem to try to improve the confidence that all DNOs would have in the way that costs incurred between 2005 and 2010 would be treated at DPCR5. This yielded some benefit in the Appendix 1 to the *Final proposals* which gives companies *more* confidence in the way that the DPCR5 opening RAV, for example, will be calculated than would have been the case at previous reviews.
- 11 One lesson emerging from this is that next time Ofgem should be looking for ways to add to the confidence of licensees by thinking about where it would be desirable to pre-commit to a particular approach at the subsequent review. As a general rule, the greater the degree of commitment that DNOs feel they can rely on, the greater the

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confidence they will have in the incentive power of the regime and in the investments that they are making.

- 12 We therefore recommend that Ofgem approaches DPCR5 conscious of the benefits of pre-commitment and that it identifies issues as the review progresses on which it would be appropriate to add to certainty and to diminish risk.

### **Assessing costs**

- 13 As a company we have always been very doubtful about the statistical soundness of Ofgem's regression techniques. We continue to be sceptical but concede that:
  - the DPCR4 regression method was more respectable than the method used at DPCR3; and
  - the normalisation exercise was much more thorough at DPCR4 than at DPCR3 – this improvement did much to diminish our concerns about the regression approach to determining efficient costs.
- 14 In our view benchmarking is a poor way to determine efficient costs. Ofgem should instead use benchmarks to inform the questions they should be asking about each DNO's FBPQ. The emphasis needs to shift from benchmarking towards assessment of business plans. The work done at DPCR4 and continuing in the cost reporting project should allow Ofgem to review data each year and, therefore, this could allow Ofgem to place more emphasis on company-specific data and less on the regression.
- 15 Ofgem should recognise that no normalisation exercise can truly correct for differences that arise from different approaches to outsourcing where the service provider is outside the DNO's group of companies.
- 16 At DPCR4 companies had to provide quantities of data for the HBPQ and FBPQs that Ofgem appeared not to use. We do not mind providing data if it is useful, but we hope that next time the information requested will be more focussed.

### **Assessing capex**

- 17 At DPCR4 we explained that the question of capex was inter-dependent with two prior questions of risk – the obvious risk that a DNO would fail to meet its obligation to distribute electricity and the, slightly less obvious, risk that a DNO might, in meeting its obligation to distribute electricity, be carrying a greater or lesser degree of risk that it might fail to achieve this within the costs projected in its plan.
- 18 Although Ofgem was *aware* of these problems it did not go very far to equalize risks in the capex assessment process. The issue of exaggerated forecasts was never really disentangled from the issue of differential risk aversion.
- 19 Ofgem's assessment of capex needs was heavily dependent on PB Power. Our impression is that PB Power's reports were not very good and there appeared to be a reluctance to finish the job off and to share the reports with DNOs in time for the discussions with the Authority.
- 20 There is something unsatisfactory about DNOs receiving allowances that will enable some to build a network that is inherently superior than any serious consideration would suggest is consistent with the willingness of customers to pay. There is the possibility that there may be developing an unintended systematic divergence in the nature of the networks across the country. If that is the case then companies like ourselves, that have not sought a step change in resilience, may be disadvantaged in future if more income is exposed to headline outcome measures like CI and CML. The next review needs to get to grips with this problem before unintended divergence becomes a serious problem.

**PART 2: CE ELECTRIC UK RESPONSE TO THE CONSULTATION QUESTIONS**

AREA OF WORK / QUESTION	Y/N	COMMENT
<b>3.4 General Principles and objectives</b>		
Were the objectives of the review appropriate? (see Appendix 2 of this document)	Y	
Did Ofgem's processes facilitate the effective delivery of these objectives (or if not, why not);	Y	
Did the manner in which Ofgem attempted to achieve these objectives conform to the principles of good regulation. ( <i>i.e Regulation and its enforcement should be proportionate, accountable, consistent, transparent and targeted</i> ).	Y	In the main Yes, but proportionality was an issue. The process involved the collection of a vast amount of data and many consultations and documents. This could be reduced in future for the benefit of all parties involved.
<b>3.7 Communication</b>		
Were the channels and methods of communication effective?	Y	
Were the appropriate individuals with responsibility for work areas within Ofgem clearly identified to interested parties?	Y	Mostly this was OK. However, during the information collection phase, requests for information post BPQ were received from many different individuals in Ofgem and it was not always clear that the information requests were coordinated.
Was Ofgem open and receptive to comment and criticism during the DPCR?	N	During the major part of the review there was no problem. However, during the licence modification process it was difficult to get acceptance by Ofgem of errors in the licence and RIGs drafting.
Did stakeholders have access to the appropriate levels of seniority within Ofgem to resolve issues as they arose?	Y	
<b>3.8 Workshops:</b> <i>Ofgem held a number of workshops during the process (2 x Network monopoly price controls, 2 x structure of charges, 2 x DPCR, 1 x distribution losses).</i>		
Were these useful?	Y	
Were there too many/too few? ( <i>Answer: M for too many, F – too few, OK – ok</i> )	OK	
Were they held at appropriate stages of the process?	Y	
<b>3.9 DNO / Ofgem working Groups</b>		
Did groups meet at an appropriate frequency?	Y	
Did participants get the opportunity to put forward their views in an open and constructive manner, ....and did Ofgem give these views appropriate consideration?	Y	In most cases, but the status of the workshops was sometimes uncertain. For instance, if a paper was presented on behalf of the industry it was not clear whether Ofgem considered this as a formal submission or whether it also needed to be formally submitted in response to a consultation.
Was Ofgem represented at an appropriate level of seniority during these meetings?	Y	
Did these groups produce meaningful outcomes, or were they generally unproductive? ( <i>Answer: M for meaningful; U for Unproductive</i> )	M	Yes, thanks to the significant input from all parties. It was not always clear what Ofgem had accepted. The minutes were very delayed. More of Ofgem's thoughts could have been provided.
<b>3.10 Preparatory work</b>		
Was the planning work (conducted primarily by the Network monopoly price control project) useful?	Y	It set off in the right direction in aiming to cover generic policy issues first but could have closed many of these off sooner than was the

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AREA OF WORK / QUESTION	Y/N	COMMENT
		case.
Did it target the areas of greatest importance for the DPCR?	Y	But potentially not in the right order. The cost of capital was left to very late in the process.
Did it give adequate consideration to the potential for radical change from previous price controls?	N	There were shocks – funding of pensions, tax, faults, etc
Was the focus on complexity, simplicity or pragmatism? (Answer: C, C or P)	P	Pragmatism
<b>3.11 Use of consultants</b>		
Were consultants used in an appropriate manner by Ofgem throughout the DPCR?	N	The use of consultants (Ernst and Young) to review support activities did not appear to significantly influence the debate on operating cost and the determinant of what is an efficiently run DNO. This work should have been done earlier. Conclusions were presented based on PBPower work before the work had been finalised and published for DNO comment. It was odd that Ernst and Young considered only a subset of costs that were included within the top down analysis
Was the output from Ofgem's consultants perceived to be fair and unbiased?	Y	Unbiased Yes, but just not very good. The quality of PB Power's analysis, and even their report writing, was very poor. It is still impossible to find from PB's reports what was actually disallowed from companies' submissions.
Should Ofgem be doing more or less of the work in-house?	?	Not sure if more work needs to be done in-house but there is a need to ensure that individuals interacting with DNO have sufficient background and knowledge of Regulation and the Industry.
<b>3.12 Consultation process</b>		
Was the overall consultation process too lengthy, about right or too short?		The duration of the process was about right but more time could have been allowed for information provision and follow-up questions. Hopefully the RRP will make this part of the process slicker during the next review.
Did Ofgem produce the right amount of material so that interested parties could understand the DPCR?	Y	
Were there too many/too few consultation documents?		About right
Were the response periods for these documents sufficient?	Y	Initially, but response periods appeared to get shorter as the end of the process approached
Was there evidence that respondents' views were considered?	Y	
Did the Ofgem documents give a fair and balanced account when respondents had contrary or conflicting views?	Y	
<b>3.13 Requests for, and use of, information</b>		
Were Ofgem's requests for information appropriate and proportionate?	N	The requirement for data for FB PQ and HB PQ was excessive and ill-defined; much of the information appeared not be used; Ofgem relied on data from only a few tables and further (different) supplementary information was requested post completion of FB PQ. Much of the supplementary data appeared to be critical and so more thought needs to be given to the efficiency methodologies and the

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AREA OF WORK / QUESTION	Y/N	COMMENT
		data required to support them – before data is requested.
Was the consultation on draft information requests useful?	Y	It was useful but many of the issues raised on usefulness and appropriateness of information were overlooked, leading to collection of data, which was of little value to Ofgem.
Did Ofgem give appropriate explanation and justification for all information requests?	N	Reason were given but on may occasions this was to provide 'background information' and to aid understanding.
Did regulatees have sufficient time to meet Ofgem's information requests?	Y	Yes, but it was a significant effort. We are looking forward to the RRP smoothing out this five-yearly cycle.
<b>3.14 Timeline</b>		
Was the publication of the timetable as early as March 2003 useful?	Y	
Were the timelines for the various work streams appropriate?	Y	
Was it appropriate to schedule the <i>Final Proposals</i> for November 2004?	Y	
Was it appropriate to issue an <i>Update</i> in September 2004, in between the Initial and <i>Final Proposals</i> ?	Y	
Which issues were addressed too soon/too late in the process?		Cost of capital, taxation and pension funding issues were addressed too late in the process. Also delays in addressing metering 'separation' as part of the process. Ofgem model was also issued too late in the process. It was inevitable that some issues would emerge only late in the day: it is merely unfortunate that the treatment of undergrounding received only superficial assessment, and that ESQCR and fluid filled cables have been deferred.
<b>3.15 Regulatory consistency</b>		
Was the content of Ofgem's <i>Final Proposals</i> consistent with the views it expressed throughout the DPCR?	Y	But treatment of pensions in tax model not clearly flagged.
Were there inconsistencies between the previous DPCR and the manner in which analysis was conducted during this DPCR?	Y	The analysis of controllable operating cost and definition of faults differed between DPCR reviews.
<b>3.16 Transparency</b>		
Were the processes and analyses conducted by Ofgem and its consultants sufficiently transparent?	N	We never saw a rational explanation of PB Power's approach.
Was the underlying data provided by DNOs sufficiently transparent?	Y	
<b>3.17 Access to Ofgem and the Authority:</b> <i>During the DPCR, both Ofgem and Authority members met with various interested parties (environmental groups, consumer and union representatives, financial analysts and DNOs).</i>		
Did groups encounter reluctance on Ofgem's part to arranging meetings?	N	
Was Ofgem properly represented at such meetings?	Y	
Were Authority members willing to engage at appropriate stages of the process?	-	
Were these meetings productive?	Y	In as much as the Authority listened, but it would have been useful to have received more feedback directly from the Authority.
<b>3.18 Further work:</b> <i>There are ongoing work streams that have arisen as a result of the DPCR, eg, cost</i>		

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AREA OF WORK / QUESTION	Y/N	COMMENT
<i>reporting, resilience and financeability.</i>		
Are the links between these work streams and the DPCR clearly defined?	N	Ofgem have not produced clear terms of reference defining all the follow-up activity (e.g. Discretionary award, undergrounding in AONBs, fluid filled cables, etc)
Are such work streams an appropriate means of dealing with the outstanding issues?	Y	
<b>3.19 Process delivery</b>		
Did the process work? Did it effectively deliver a price control in a cost efficient manner?		It was very resource intensive. It would be interesting to know whether Ofgem completed the work within its original budget.
Did Ofgem deploy sufficient resource, too much or too little and at the right time in the process?	Y	There were some bottlenecks, particularly clearing some items through the cost assessment group.
Were Ofgem teams comprised of the correct range of competencies to deliver an effective price control?	Y	
<b>3.20 Positive points</b>		
What parts of the process worked well?		Overall, a small evolutionary step from last time: the working groups worked well in allowing less formal discussion before each party established published positions.
Which elements added the most value to the process?		
What aspects should be retained for future reviews?		
<b>3.21 Potential improvements</b>		
Were there any flaws in the process?		Collection of too much data. Need to reduce volume of irrelevant data for BPQ's.
How could the overall process be improved?		Ofgem should set out clearly the intended uses for data collected and have the cashflow model available early in the process to aid transparency.
What were the biggest problems?		Data collection on a retrospective basis. Collection of information for consultants.
What change should be made to the process to avoid a repetition of these problems?		Ofgem should set out clearly the intended uses for data collected and have the cashflow model available early in the process to aid transparency.
<b>3.22 Other issues</b>		
Have any issues been omitted from the above lists?	N	
Are there any other observations or comments that should be made regarding the DPCR?	N	
Are there other issues Ofgem should be addressing in 2005 and 2006 as early preparation for DPCR5?	N	<ul style="list-style-type: none"> <li>• an assessment of the cost v risk balance</li> <li>• an assessment of outputs, including resilience, visual amenity, etc.</li> <li>• a blue-sky review of the building blocks of price control, from whether RPI-X remains appropriate to cost allocation issues</li> <li>• early definition, following this review, of the mechanics of the cost assessment process, to establish a tightly focussed BPQ (if one is needed post RRP) to benefit both Ofgem and distributors.</li> </ul>