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Dear Paul,

ASSESSMENT OF THE ELECTRICITY PRICE CONTROL REVIEW PROCESS

Thank you for the opportunity to respond to the above document and thank you again for permitting me to speak at Ofgem's recent public workshop. I am pleased to confirm that Ofgem can publish this response on its website.

It is clear to us that much of the last price control review was done well and marked a distinct improvement over DPCR3. Ofgem, and in particular its DPCR4 team, are to be congratulated for this. Improvements were seen in a range of important areas, including communications with the DNOs through working groups and meetings with Authority members, transparency of process and decision making, the recognition of the pension and taxation issues, as well as improved target setting for quality of supply.

There were also some areas where improvement over DPCR3 was less than expected. Chief amongst these was Ofgem's approach to benchmarking for both opex and capex. Both areas relied on simple models that are not well supported by robust research (particularly regarding opex). This is no doubt partly due to the weaknesses that persisted with regard to the collection of robust and comparable cost data – a failure for which Ofgem and DNOs were collectively responsible. But there also appears to be a desire in Ofgem for simplicity in its cost benchmarking models that perhaps inhibits further development. However, such a situation cannot persist as DNOs reduce cost levels further in response to price control incentives. It is clear that the degree of risk inherent in simplistic modelling is becoming an increasingly untenable and could lead to perverse outcomes (such as the substitution of maintenance by replacement capex).

Ofgem has the opportunity through its Regulatory Reporting Pack process not only to develop more robust data (validated through detailed audits), but also to better understand the cost drivers at work and produce more robust benchmarking models. For example, the DPCR4 opex/faults regressions did not recognise even the basic differences in unit costs between overhead and underground assets (which put DNOs with predominantly urban networks at a distinct disadvantage) even though such differences are self evident to those who run these businesses. There is a clear opportunity to correct such weaknesses through the RRP process and as a result deliver a price control regime that reduces the risk of inappropriate outcomes (i.e. which better protects consumers' interests).

We explore these and other areas in the appendix attached to this letter. We hope that Ofgem finds our comments useful, balanced and constructive.

Yours sincerely

Paul Delamare
Head of Regulation and Strategy (Networks)

General principles and objectives

We continue to believe that the objectives of the review were appropriate. In particular, we believe that Ofgem's focus on incentivising appropriate outputs from DNOs was, and remains, the correct approach.

Opex benchmarking

We are not convinced that Ofgem is able to know whether its objective of providing appropriate incentives to DNOs to operate their networks in an economic, efficient and co-ordinated manner has been achieved. We say this because Ofgem primarily sets its allowances for operating costs using a simplistic high level regression model based on just three variables (i.e. the CSV), which has no proven theoretical or empirical underpinning. As a result Ofgem can, at best, have incomplete knowledge as to why one DNO is apparently more efficient/lower cost than another (this is particularly the case when the top-down benchmarking is not accompanied by a full and in-depth bottom-up benchmarking approach as was the case in DPCR4).

Ofgem is therefore not able to demonstrate that such differences are not merely the result of differing**:**

- operating conditions (e.g. rural overhead and urban underground assets have very different cost drivers and profiles but these are not reflected in the model);

- levels of maintenance between DNO, (which may lead to a perverse (from a customer's perspective) preference for replacement capex;

- levels of operational risk arising from asset condition.

In these circumstances is not clear to us how Ofgem is able to know whether it has fulfilled it primary statutory duty of protecting the interests of consumers.

The development of the Regulatory Reporting Pack and the associated improvements in data consistency and comparability expected to result provides a good opportunity for Ofgem to re-examine its approach to benchmarking and to work with the industry to develop improved econometric models well ahead of DPCR5. We will strongly support such work.

Environmental responsibilities

Ofgem's environmental responsibilities in respect of the National Parks and Access to the Countryside Act 1949 (as amended by the Environment Act 1995) and the Countryside and Rights of Way Act 2000 seemed to become clear only towards the end of the process. We believe that a clearer exposition of the totality of Ofgem's statutory responsibilities as part of the objective setting exercise would have helped.

Communication

The channels of communication between Ofgem and the companies were generally good, and a marked improvement on the arrangements for DPCR3. We have set out below a number of suggested areas for further improvement next time.

Discussions with Authority members

The opportunity to present our case directly to Authority members was a welcome innovation and one that should continue for future reviews. In terms of improving the process we would suggest**:**

- Having longer meetings which permit more in depth explanation and discussion of often complex issues;
- Equal time given to each licensee - EDF Energy has three licensees (7.6m customers), but was given the same amount of time with Authority members as United Utilities (one licensee, 2.3m customers) – NB. we do not suggest giving less time to UU;
- Ofgem sharing any briefing materials provided to Authority members prior to the meeting;
- Specific feedback from Authority members after the meeting, including any additional questions.

Working level communications

It has also been suggested that a forum for discussion between Ofgem and DNO Regulation Managers is formally established – we would support this. During DPCR4 the Incentives Working Group effectively became such a forum and provided a good opportunity for all concerned to share points of view and to test out ideas.

Communications within Ofgem

Some groups of staff within Ofgem who were not part of the main DPCR team, but who nevertheless had an important role to play, often appeared to be a little disconnected from the process. The most notable example of this was in respect of metering, where clarity on Ofgem proposals surfaced only towards the end of the review. Also, Ofgem's technical directorate, who in our view have a critical role to play in forming robust judgements about capex and opex (e.g. faults, maintenance) and allowances for quality of supply maintenance and improvements appeared to be not always involved in the process. We note that the technical team now sits in the Networks Division, which is a welcome development that should facilitate their greater involvement at future reviews.

Workshops

The workshops held at the start of the process were useful for discussing the high level issues that needed to be addressed. It was also useful as a forum for Ofgem and DNOs to hear the views of other interested parties, for example academics and city institutions. It may have been beneficial to have held a workshop after the initial proposals or September update to gather the views of interested parties.

DNO/Ofgem working groups

We continue to believe that the working groups are a valuable addition to the price control process in terms of increasing the opportunities for communication, and for developing mutual understanding. In our view there was a need for better communications between groups (by both Ofgem and the DNOs). In particular, the scope of the Cost Assessment Group and its interface with the Incentive and Quality of Supply groups often appeared unclear (a problem possibly exacerbated by the Cost Assessment Group not producing notes of its proceedings). We have noted above that forming a senior group attended by Ofgem senior management and DNO regulation managers would improve communication (and formalise the role that the Incentives Group took). Such a forum could also be used to co-ordinate the work of other groups, e.g. by having the chairs of the other groups present to deliver short reports on their respective activities.

Preparatory work

Our views on Ofgem's DPCR4 preparatory work are mixed. Firstly, it is clear that Ofgem and the DNOs' work on regulatory accounts did not adequately address the price control building blocks in terms of the detailed specification of DNO activities and their associated costs as well as the need for detailed audits. As a result, the normalisation of costs during the review consumed significant amounts of both Ofgem and DNO resource (whilst still leaving important differences between companies unadjusted, in our view).

Ofgem's initial work on developing monopoly price controls was a good start. In particular the work on developing the incentive framework, on mechanisms for dealing with uncertainty and on benchmarking provided the basis for improvements in these important areas. However, it is our impression that progress in these areas was not carried foreword into the review as well as expected. This may have been because of a change in Ofgem's senior management in this area which resulted in a lower priority to these aspects or it may have been because data problems limited the opportunity to explore more sophisticated approaches. It is our hope and expectation that once the data available to Ofgem has improved under the RRP arrangements the above areas can be revisited by both DNOs and Ofgem and that improvements to the, incentive, uncertainty and benchmarking framework are developed and put in place for DPCR5.

Use of consultants

We believe that Ofgem's decision to develop an in-house capability to carry out the opex/faults cost assessment work was the correct one, since it is important for it to develop its knowledge base for the development and refinement of the RRP and for the interpretation of data provided.

Ernst and Young study

We have commented above on the limitations of Ofgem's current top-down approach to establishing relative efficiency with regard to opex/faults costs. In such circumstances it is particularly important that the results of the top-down work are supported/validated by a comprehensive bottom-up analysis. However, Ofgem seemed to deliberately limit the scope of Ernst and Young's (E&Y's) analysis to "a subset of operating costs – predominantly overheads and other corporate costs" thus severely limited its usefulness as validation for the top-down regression models (which had a much broader scope particularly regarding the costs of operational activities).

It is perhaps not surprising that Ofgem's reference to E&Y's work is limited to just one paragraph in its June 2004 initial proposals paper, a seemingly retrograde step compared to the roughly equal billing given to top-down and bottom-up benchmarking used in DPCR3. Furthermore, even within the limited scope of work referred to above, we believe that E&Y were employed late in the day and were not given sufficient time to carry out a suitably robust and useful study.

E&Ys final reports have never been made available to the DNOs. This should be rectified.

PB Power

With regard to the work of PB Power (PBP), we believe that a number of improvements can be made. Firstly, it would have been beneficial for PBP to have been brought into the price control at an early stage in the process. This would have clearly helped to ensure that the data requirements were agreed prior to the design of the business planning questionnaires (BPQs). This would have avoided much rework and answering of questions by DNOs.

More fundamentally however, we believe that Ofgem should have consulted on the terms of reference for its use of consultants in this fundamental area. It is our belief that PB Power was not permitted sufficient time and resource to carry out anything more than basic modelling and that as a result was unable to engage with us on many important investment drivers not captured by this modelling.

Based on our analysis of PB Power's reports for the respective DNOs it is clear to us that inconsistencies exist. It is possible that such problems may have resulted from PBP not being permitted sufficient time and resource to resolve these. We consider that consultation on the terms of reference (including the budget) by Ofgem would have enabled such problems to have been foreseen.

<u>Capex modelling</u>

The general approach to assessing DNOs' capex plans consisted of modelling load and non-load related elements, comparing these with the FBPQ submissions and seeking evidence to support significant differences before forming a "judgement". There were two problems with this:

- The models are relatively simple and in particular do not take account of local circumstances (e.g salt corrosion, summer peaking loads, type failures, operational restrictions etc);

- The consultant's judgements, such as the derivation of unit costs, were largely opaque, and probably not replicable.

It is clear to us the improvements to this fundamental part of the review process are required and that Ofgem should seek to do this ahead of the next review. However, this raises an issue as to whether consultants are used, since it would seem difficult to improve their modelling before their DPCR5 appointment. It may also be the case that consultants are reluctant to share details of their modelling and approach since this can represent their unique selling point with regard to their competitors. Indeed we note that PB Power's models were not made available to DNOs, unlike the QoS and financial models. We therefore believe that if the necessary improvements are to be made Ofgem should bring the modelling in-house.

Not only would in-house capex modelling bring Ofgem's technical team more into the heart of the process, it would also facilitate links with the Asset Risk Management (ARM) reviews – which are clearly precursors of price control reviews. It would also enable Ofgem to develop its knowledge base, particularly regarding asset condition issues and would facilitate consistency between one review and the next.

Ofgem introduced a sliding scale mechanism to help resolve differences between the PB Power's views and those of the DNOs. Improved modelling may reduce the need for such an approach, or at least it would ensure that it is better calibrated.

Consultation process

The overall consultation process was lengthy, but this was probably driven by the issues around data collection and normalisation. We expect the RRP process to shorten the time required for DPCR5.

Generally, the consultations contained the right amount of material for areas where Ofgem had made progress, the response period for consultations was generally sufficient, and the documents generally seemed to give a fair representation of opposing views.

At Ofgem's recent public workshop, supplier representatives noted that they found it difficult to forecast changes in tariffs from the published P0 movements. We have some sympathy with their predicament and will work with Ofgem to provide timely information for suppliers next time.

Requests for, and use of, information

The most efficient way of collecting data is to first establish the processes that will use it. In the context of the review this means that Ofgem should specify (and test) its benchmarking models and then design the data collection arrangements to provide the appropriate inputs to them. However, Ofgem seems reluctant to do this (seeming to prefer a different approach each time) with the result that it requests large amounts of information which it subsequently does not use (a criticism that was equally valid of DPCR3).

A good example of the above concerns the capex modelling. At the time of BPQ completion Ofgem did not fully understand the data required for the consultant's models since they had not yet been appointed. As a result, the consultants had to make separate requests for further data from the DNOs.

Sharing of information across consultants can be improved – e.g. those working on opex issues appeared unaware of data given to the capex consultants.

Timeline

The early publication of a DPCR timeline was useful. However, it appeared to be stuck to slavishly even though some published documents did not contain much new information.

A number of key issues was left until the final proposals, most notably the cost of capital and value of the RAVs. Deliberately delaying further consideration of the cost of capital until the end of the process was in our view not particularly helpful to the process.

Regulatory consistency

There was a reasonable degree of consistency between DPCR3 and DPCR4 in terms of the high level process. However, a few notable areas of inconsistency stand out:

- Ofgem changed the Composite Scale Variable in an opaque manner and apparently without evidence (e.g. the views of its consultants were not published), which had a major effect on the efficiency position of some DNOs (notably LPN);

- The DPCR4 bottom-up efficiency benchmarking (by Ernst and Young) had a narrower scope that the DPCR3 analysis carried out by Pannell Kerr Forster) which made it difficult to compare to the top-down regression work – which we regard as a substantial weakness in the DPCR4 process.

Transparency

This was generally an area of commendable improvement on DPCR3. The sharing of data on the normalisation process was particularly welcome, as was Ofgem's provision of its financial model. A number of areas of opacity have been identified elsewhere in this response. The main ones are:

- The basis of judgements made by the capex consultants
- Ofgem's changes to the opex regression CSV – including the consultants advice
- Non-provision to DNOs of E&Y final reports
- Non-provision of briefing material provided to Authority members

Further work

<u>RRP</u>

The price control highlighted need for more consistent and comparable data. In our view the RRP process can achieve this if it accompanied by robust audit of both financial and non-financial data and by the publication of DNO data wherever possible. We understand that Ofgem has not yet reached a conclusion on these aspects, but we are reassured that it fully understands our views and the reasons for them.

<u>Financeability</u>

The relationship between RAVs, cash generation, increasing capital expenditure and the cost of capital is a core issue on which Ofgem should be seeking to provide both companies and investors with greater clarity than that provided in DPCR4 (where the additional allowance given to SPN was described as "not necessarily the most appropriate response were other companies (or SPN at a different review) faced with similar financial indicators").

We believe that Ofgem must provide clarity regarding its policy in this area and that an opportunity to do this is provided by work arising from the DTI/HM Treasury paper "The drivers and public policy consequences of increasing gearing". It would be useful for Ofgem to set out a timetable for this work.

<u>Resilience</u>

The continuation of the Quality of Supply Working Group is welcomed as is the broadening of its remit to include resilience issues. We regard it as helpful for future reviews (and more generally) for Ofgem to have a greater understanding of asset condition and associated asset risk in order to inform future judgement on capex (replacement) and opex (faults and inspections/maintenance) benchmarking.

Process delivery

The process worked in the sense that no companies sought referral to the Competition Commission. However, it is clear from our comments above that there is room for improvement in many basic areas, in particular; data collection, data validation, and top-down and bottom-up benchmarking both in respect of capex and opex. – i.e. the core building blocks of the review.

In terms of resource, we have some concerns that too little resource was applied by Ofgem early on in the process and that some key elements appeared to be planned rather late in the day, for example the E&Y study. It is also clear from our views above that technical resource is needed from the outset, and that this is better carried out in-house if an improvement to capex and opex modelling/benchmarking is to be carried out between reviews.

We have also noted above that were aspects of the review where the responsibility of other parts of Ofgem organisation (notably metering) did not appear to be sufficiently integrated into the process. Also, we have suggested that working groups report into a lead group comprising of senior Ofgem and DNO regulatory personnel, as this would improve co-ordination and overall programme management of the review.

Positive points

We regard the elements of the review that worked particularly well as:

- Communication (working groups, visits, workshops, Authority meetings, one-to-one meetings etc.)
- Early recognition of the time required to draft the licence modifications (we regard the Legal issues Working Group as having made a particularly useful contribution),
- Increased transparency (circulation of data, publication of some models, increased clarity of decision making, no unsupportable "within range adjustments"),
- Recognition and resolution of the pension and tax issues,
- Improve QoS target setting, treatment of storms,
- Recognition of environmental and social dimensions (losses, undergrounding, discretionary reward).

Potential improvements

As we have noted above, there are a number of areas for improvement:

- Data collection and validation,
- Opex and capex models and benchmarking ,
- Timing of the cost of capital decision,
- Role of Ofgem's technical function,
- Internal co-ordination, in both Ofgem and the DNOs,
- Co-ordination of working groups,

- Improved understanding of asset condition and asset risk issues,
- Engagement by Ofgem with evidence submitted (e.g. regional cost data),
- Developing and enduring policy on financeability,
- Quality control by Ofgem lawyers regarding licence modification drafting.

EDF Energy
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