

Assessment of the Electricity Distribution Price Control Review Process

Conclusions

July 2005 175/05

Summary

The project to set the new price controls on the electricity distribution businesses – which will cover the period 1 April 2005 to 31 March 2010 – concluded recently, and has resulted in total revenue allowances for distribution licensees in excess of £3 billion per year over the five year period.

Ofgem has undertaken an assessment of the price control process, to determine what lessons might be learnt to inform the process to be followed in future reviews. This document provides an overview of the responses to the consultation and sets out the resulting conclusions.

In general, the price control review process was seen as a substantial improvement on previous reviews, particularly in terms of transparency. Respondents welcomed the role of the Authority Committee which met with each distribution company management team at three stages in the process, the extensive use of working groups to improve dialogue and understanding and early publication of and successful delivery to a detailed timetable.

However, there were substantive criticisms and areas identified for improvement at future reviews. It is generally recognised and accepted that the process of data collection did not work well and that annual information gathering is likely to be the best way to improve matters. Ofgem and the distribution companies have already put significant effort over the last eight months into working together on a new system of cost reporting – the initial results of which (in respect of 2004/05 data) will be published later this year.

Other lessons for the overall process are set out here, including proposals to reduce the number of consultation documents and concurrent projects, resolve policy issues in a phased way but subject to the necessary evidence being available, give more weight to the views of non-licensee stakeholders and better integrate the Ofgem project team (including consultants).

It is not the purpose of this document to discuss or recommend any changes to the policy issues underpinning the review.

The recommendations of this post-project assessment are already being considered in the planning of the transmission and gas distribution price reviews, recognising that the circumstances of each review differ and will likely make different processes appropriate

in each case. The initial consultation on the transmission review was issued recently and an initial consultation on the gas distribution review is planned towards the end of 2005.

Ofgem intends that these recommendations will also feed into the next electricity distribution price control review. While planning and preparatory work for that review will likely commence in 2007, the first major consultation document of the review is more likely to appear in the spring or early summer of 2008. Ofgem's priorities for 2005 and 2006 in the regulation of electricity distribution relate to cost reporting and to improving arrangements for charging and commercial relationships (not least in the light of the impact on distributed generation), while continuing to improve understanding of key longer term issues such as asset risk management and network resilience.

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1. Introduction

- 1.1. Ofgem's principle objective is to protect the interests of consumers (present and future), wherever appropriate by promoting effective competition.
- 1.2. Electricity Distribution Network Operators (DNOs) distribute electricity to consumers through networks of wires and underground cables. DNOs retain an effective monopoly in the core services that they provide to consumers, because it is not possible or appropriate to introduce competition. In these circumstances, Ofgem seeks to protect the interests of consumers through a variety of regulatory tools, such as price controls and standards of performance.
- 1.3. The recent electricity Distribution Price Control Review (DPCR), which relates to the period 1 April 2005 – 31 March 2010, has resulted in total revenue allowances for DNOs in excess of £3 billion per year over the five year period. These revenues are recouped from consumers through Distribution Use of System charges levied by DNOs. Given the magnitude of the monetary sums involved in the DPCR, it is essential that the process for establishing the allowed revenues of DNOs is robust and consistent with Ofgem's statutory duties.
- 1.4. In light of this, Ofgem has assessed the processes that it used during the DPCR, particularly with regards to consultation and decision making. The purpose of this document is to summarise responses from interested parties on how Ofgem conducted the DPCR and to set out Ofgem's conclusions on the lessons for future reviews.

Structure of this document

- 1.5. The structure of the remainder of this document is as follows:
 - ◆ summary of responses (Chapter 2) - this Chapter gives a brief overview of the various responses to Ofgem's consultation paper¹; and
 - ◆ conclusions (Chapter 3) – this Chapter outlines the lessons that can be drawn for future reviews.

Points raised in an open workshop held in May 2005 are noted in an Appendix.

Next steps

- 1.6. Ofgem has recently published the first consultation on the transmission price control review and intends to publish an initial paper on the gas distribution price control review towards the end of the year. The lessons from this post-project assessment have been considered in planning these reviews.
- 1.7. In terms of electricity distribution, the initial results of the cost reporting project will be published towards the end of 2005. Ofgem would not expect the next electricity distribution price control review to commence formally until 2008, although planning and preparatory work may commence in 2007 subject to priorities at the time.
- 1.8. Ofgem is also undertaking a study in conjunction with Ofwat (and potentially other regulators) on financeability issues and expects to publish a paper for consultation in due course.
- 1.9. Any questions on this document should be directed to Martin Crouch, Director, Electricity Distribution, Ofgem, 9 Millbank, London SW1P 3GE (email: martin.crouch@ofgem.gov.uk or telephone 020 7901 7255).

¹ Assessment of the Electricity Distribution Price Control Process, March 2005, 91/05

2. Responses to consultation

Background

- 2.1. In order to assess the process used in the electricity distribution price control review, Ofgem has consulted openly with external parties through a consultation document published in March 2005² and two workshops and has discussed the process among the project team and management, consultants and Authority members.
- 2.2. The March 2005 consultation summarised the review process and asked various questions regarding the value of different aspects of the process and the potential for improvements.
- 2.3. Thirteen responses were received – one from each of the 7 DNO groups, 3 from suppliers (Centrica, E.ON UK and RWE npower), and one from each of NGT, Friends of the Lake District and Ruddie Merz. The following sections highlight a selection of the points made – they are not intended to be exhaustive and all of the full responses are available on Ofgem’s website (www.ofgem.gov.uk) in the “Distribution Price Control” area of work.
- 2.4. The post-project review was focussed on the process rather than policy decisions/outcomes. However, it is inevitably difficult to divorce the two. Responses on policy issues are generally not discussed in this document.

Non-DNO Views

- 2.5. Each of the suppliers that responded expressed concerns about the difference between tariff changes and published POs (the initial change in allowed revenue) and about their opportunity or ability to influence the process.
- 2.6. Some respondents wanted more detailed explanations of policy decisions (for example, for Ofgem’s documents to provide reasons for rejecting each

² Assessment of the Electricity Distribution Price Control Process, March 2005, 91/05

comment) but there were also desires for simpler explanations that were more readily accessible to non-specialists.

- 2.7. Two respondents suggested that it may be useful to have a customer or supplier working group, to improve interaction and understanding with groups other than the licensees. One respondent saw a particular problem with the short gap between the proposals update (published in September 2004) and Final Proposals (November 2004).
- 2.8. Respondents also noted some concern that Ofgem was too close to the DNOs.

DNO Views

- 2.9. There was significant variation in the views expressed by DNOs; however, some common themes can be identified. All of the DNOs have commented that the process was significantly improved from previous reviews. Among the points raised were:

<i>Working Groups:</i>	Unanimous support; request for a coordinating group and more complete/timely minuting.
<i>Authority Committee:</i>	Generally strongly welcomed; request for more direct feedback and in one case for longer meetings.
<i>Access to senior management:</i>	Generally very positive, with one DNO expressing a reservation regarding the period between September and November 2004.
<i>Transparency:</i>	Generally positive, with some exceptions (such as the model used to assess capital expenditure).
<i>Data/business plan questionnaire:</i>	The process of data collection was roundly criticised. Particular points raised included that much of the data collected was not used and that consultants were not involved prior to finalising the request, leading to follow up questions. DNOs did support the split between historic and forecast data requests. It was generally accepted that the cost reporting project was the right response to these problems.

<i>Early resolution of policy issues:</i>	Some complimented the intent to resolve policies earlier and some commented that issues were progressively narrowed as the review progressed. However, there was a general view that more could have been resolved earlier including the cost of capital. In particular, some DNOs thought that cost assessment methodologies should be decided earlier (even absent data and/or before business plans submitted).
<i>Preparatory work (in 2002/early 2003):</i>	There was general support for period of policy discussion before the review proper commenced, with some recognition that this became a distraction in the spring/summer of 2003.
<i>Capex assessment:</i>	Some DNOs criticised the approach taken, sometimes expressed as a process issue (e.g. consultants' budget) but reflected in desire to know which projects Ofgem disallowed. There were requests for more in-house work/involvement of Ofgem technical staff.
<i>Opex assessment:</i>	There was criticism of benchmarking from some and it was generally felt that the bottom-up process benchmarking assessment was too narrow in scope.
<i>Customer willingness to pay surveys:</i>	Some DNOs felt that Ofgem did not organise the willingness to pay surveys effectively or use the results appropriately.
<i>Project management:</i>	Generally positive view regarding delivery to published timetable, but also that project management could have been more focused and more effort put into coordination between workstreams (especially but not only metering).
<i>Explanation of decisions:</i>	Some desire for more/earlier Impact Assessments and more detailed feedback in consultation documents on company-specific arguments.
<i>Volume of consultations:</i>	There was little enthusiasm for Ofgem's suggestion that it would be possible to reduce the number of consultation documents and indeed some opposition to any reduction.

<i>Simplicity:</i>	Most DNOs took the view that the approach to cost assessment was too simplistic, although one explicitly advocated simpler solutions.
<i>Licence modification drafting:</i>	DNOs welcomed the comparatively early start to the licence modification drafting, but considered that an even earlier start could have clarified Ofgem's intentions on how policy decisions would be implemented.
<i>Future work:</i>	Widespread support for work on cost reporting, network resilience/risk and financeability. A couple of DNOs suggested that Ofgem should undertake a fundamental review of RPI-X and/or of cost assessment methodologies, although one DNO opposed this.

Discussion

- 2.10. Ofgem is grateful to all respondents for their views and suggestions. All of the responses have been considered in full in drawing up the conclusions in the next chapter, not just the summary points reflected above.
- 2.11. Ofgem notes the general flavour of DNO responses would be to add to the workload of the price review project through more meetings and documentation, more detailed and sophisticated analysis and more preparatory work. However, not all DNOs shared this view and even those that did appeared to consider that less data would be required.
- 2.12. One of the striking features of the responses is the difference between many of the views expressed here and those raised in consultation on Ofgem's corporate plan, in terms of the desire for more detailed and extensive analysis and consultation. Ofgem is currently considering how it can reduce the volume and improve the effectiveness of its consultations across all its work and would expect the results of this work ("Project Paperless") to impact on future price review projects.

3. Conclusions

- 3.1. Taking account of the views expressed, but based on Ofgem's statutory duties and continued focus on better regulation, the recommended conclusions from the post-project review are set out below.
- 3.2. It is intended that these conclusions will be considered in planning the upcoming transmission and gas distribution reviews and then the electricity distribution review for implementation in 2010. However it is recognised that the differing circumstances of each review will have a significant impact on the design of the process and that it is more important to reflect current priorities at the time than to follow these conclusions. Ofgem will also consider any relevant lessons emerging from reviews of other projects, including any in relation to price reviews conducted by other regulators.

Overall process

- 3.3. There were successful features of the process that it is recommended continue in future reviews, adapted as appropriate:
- ◆ an Authority Committee to meet each licensee management team at key points in the process;
 - ◆ licensee-Ofgem working groups on each major workstream, with a general liaison group (but not a joint decision-making body);
 - ◆ several visits to each company during cost assessment attended by Ofgem staff as well as consultants (if used);
 - ◆ general transparency of analysis and reasons for decisions; and
 - ◆ publication of a reasonably detailed timetable as soon as the project team can be confident that it is deliverable.
- 3.4. If possible, it would be preferable to avoid other major projects being run at the same time as the price review which either affect the same industry participants or engage the same Ofgem staff.

Consultation/proposals documents

- 3.5. There were too many (seven) consultation and proposals documents in the 18 month period leading to final proposals. Fewer documents (e.g. perhaps five) should suffice, although additional documents may be needed if there are other overlapping projects such as a roll-over of the previous price control. Also it would be preferable to leave longer gaps between documents in the later stages (more than 2 months).
- 3.6. Ofgem does not agree with the suggestion that the documents should be more detailed (subject to Project Paperless review). Similarly, there should not be more Impact Assessments and they should not start earlier (the initial draft impact assessment was included in the first consultation paper) – however, Ofgem agrees that the work on the Impact Assessments should be more heavily weighted towards the early part of the review than occurred with DPCR4.
- 3.7. In terms of timing, publication of final proposals in the November before implementation was generally supported. The appropriate timing for the start of the review is likely to be more dependent on the issues under consideration and other priorities. Publication of the proposals documents on Monday mornings followed by analyst conference calls appeared to work reasonably well.

Data gathering

- 3.8. A clear recommendation is to institute annual cost reporting and to ensure that this is resourced appropriately. The annual reporting will need to evolve over time to ensure it collects the most useful information without imposing excessive burdens. The information collected should be sufficient to calculate the regulatory asset value.
- 3.9. Even with annual cost reporting, additional information will almost certainly be needed at each review (for example, companies' forecasts of future costs). In collecting this information, it should be recognised that the use of a large business plan questionnaire requires interaction on the data and interpretation of questions if the risks of mis-specified answers are to be managed. Use of subsets

of data and/or trial completion may help. There may be other ways of collecting information that could be considered.

- 3.10. Any resubmissions of data should be managed carefully, with strict version control and pre-defined submission dates.
- 3.11. Decisions on publication of data should be taken early in the process.

Early policy decisions

- 3.12. It is appropriate to aim to resolve as much of the policy framework (e.g. duration and scope of the control, range of incentives, methodologies to be used, etc) as early as practicable but policy decisions should not be taken in isolation from data/evidence. Ofgem will need to retain flexibility to amend initial views during the consultation process in the light of responses and of new information and/or analysis.
- 3.13. The timing of network price reviews in the coming years will mean that there is not a full year without a review underway as there was in 2002/03. Nonetheless, it will still be useful to engage with the licensees (and other stakeholders) before the review proper starts, but even more important to avoid this encroaching upon the review timetable.
- 3.14. As each review progresses, it is useful to start consideration of the detailed licence modifications early to embed early policy decisions in legal drafting as soon as possible – certainly by initial proposals - and have a full draft published by Final Proposals at the latest. Early drafting helps to clarify the detail on how policies will be implemented, reducing the scope for misinterpretation of what is intended.
- 3.15. Early consideration should be given to the form of any customer survey given the significant lead times to design and undertake the survey, in view of the desirability of the results being available relatively early in the process.

Non-licensee views

- 3.16. It is important to prioritise continuing engagement with non-licensee stakeholders through to the later stages of the process. Given the range of

potential interested parties it seems likely that the best way to achieve this would be to hold additional workshops later in the process (including at least one after initial proposals).

- 3.17. Further consideration is needed to presentation of revenue changes and in particular, translating any revenue changes into tariff changes. It is recognised that this may be difficult due to responsibility for setting tariffs being with the DNOs rather than Ofgem, but greater clarity over likely tariff changes should be provided.

Consultants

- 3.18. Decisions on the use and scope of consultants should be made earlier in the review if possible, at around the time of the initial consultation paper where this is practical. Any consultants working on cost assessment should be engaged prior to finalising data requests and careful consideration should be given to their scope of work.

Internal organisation

- 3.19. It seems likely that conduct of the review would benefit from appointment of a dedicated project manager and from integration of the whole price review team as far as possible (including technical expertise).

Appendix 1 Summary of May workshop

Summary of DPCR4 Process Assessment Workshop, 12 May 2005

Venue: Ofgem, 9 Millbank

The workshop began with Ofgem presenting a brief timeline of the DPCR4 process and highlighting a number of process issues for consideration by the attendees. The floor was then opened for questions to Ofgem management; key points raised were:

- ◆ One attendee considered that there had been too many publications within the project timeline; at the stage by which responses had been received by Ofgem, the succeeding document was already significantly drafted. As a consequence, he felt that (a) the documents didn't clearly demonstrate how Ofgem had considered his responses; and (b) the Ofgem view was excessively focussed on the issues that DNOs had raised, to the detriment of those less involved in the process.
- ◆ Another attendee noted that the DPCR4 ran concurrent with the BETTA project, which meant that small distributed generators did not have the time to adequately represent their views. Ofgem noted the problems of large projects running concurrently and stated that this would be considered, where possible, in the future scheduling of work. It also stated that the DGCG had provided input on the requirements for distributed generation and there had also been feedback through the structure of charges workshops.
- ◆ A number of supply company representatives highlighted the disparity between the P₀ and X figures quoted in the Final Proposals and the subsequent changes in DUoS charges. They considered that it is the real change in charges that consumers are interested in, and the Final Proposals had created customer expectations that had been difficult for suppliers to manage. Ofgem agreed to consider if there is a more meaningful method to present the results of the review, but noted that Ofgem sets allowed revenues; it is for the DNOs to set their tariffs. The DPCR4 outcome was also complicated by the effect of tariff rebalancing, which was not known at the time of Final Proposals.

EDF Energy gave a presentation which focused on issues relating to capex, particularly the transparency of the consultants' model, data gathering and the use of Ofgem resources. The ensuing discussion raised the following issues:

- ◆ A DNO questioned the level of consideration Ofgem gave to the "DNO case" in the business plan questionnaire submissions. Ofgem responded that these scenarios did not appear to have been fully thought through and did not offer analysis of clear consumer benefits. Another DNO was sceptical that Ofgem would have considered any unique solution for a DNO, but Ofgem reaffirmed that if it was presented sufficiently early in the process and could be clearly demonstrated to be in consumers' best interest, Ofgem would be required to give it serious consideration.
- ◆ Whereas there was general support for the aims of the willingness to pay (WTP) work, it was recognised that in its current one-off form, it is difficult to be confident in the outcomes. Ofgem noted that the Authority needs robust evidence before it could approve significant additional discretionary network expenditure. Attendees suggested that there could be regular repeat surveys so that a more reliable data set would inform the Authority's opinion.
- ◆ One attendee commented that Ofgem's reluctance to commit at an early stage to a cost of capital figure indicated that Ofgem sees cost of capital as a major variable within the overall settlement package. He considered that this separation of the end figure from the relatively mechanistic values suggested by current market indicators could undermine investor confidence in the process. Ofgem replied that the position adopted is partly due to the uncertainty in the stability of low debt rates and therefore a reluctance to change the rate between successive reviews too much, since the majority of capex is related to long-term investments.

For the final presentation, Ofgem gave an overview of the forthcoming work program of the Distribution Directorate. This centred on the DPCR follow-up, structure of charges and commercial governance arrangements. Comments were received in relation to the possibility of monitoring tax payments made by DNOs during the DPCR4 period, the development of the incentive regime for distributed generation, the process for bottom-up modelling of capex and the timing of future structure of charges work.