Consumer Focus
Campaigning for a fair deal

5 June 2009

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Dear Rachel

Electricity Distribution Price Control Review Methodology and Initial Results Paper

Consumer Focus welcomes the opportunity to respond to this consultation. We set out below our views on the position reached and the firm proposals to date and highlight some of the key issues we think arise from the process for consumers.

The consultation and supporting documents represent together a lucid run through of the process pursued so far and the methodologies being followed or proposed, although the documentation is (understandably) somewhat technical in places. Overall it is a helpful interim explanation as Ofgem progresses into the middle game of what is probably the most difficult network price reset carried out by the energy regulator/s to date. Given the depth and density of the material it would have been helpful to have a longer consultation period and a public set of presentations from Ofgem on the key themes.

Cost forecasts, operational cost assessment and core network investment

The DNOs have bid for substantial increases in allowed revenues over their next price control period to fund network investment and increase operating costs, and it is hard to escape the feeling that they are being opportunistic. Ofgem has calculated that the overall increase in their bids alone over DPCR4, before taking into account issues such as the cost of capital and possible new incentives, could lead to increases of an average of around 12% of the distribution element of customers' electricity bills. This would represent an increase of over £60 a year for domestic customers; business customers would face higher increases. Such increases would occur at a time when increasing numbers of consumers are slipping into fuel poverty and many small businesses are failing. We note that the investments requested range from 41-80%. Although the state of networks and the challenges each DNO faces obviously vary, the width of this spread indicates marked differences in assumptions and overbidding.

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Consumer Focus acknowledges that continued volatility in the economy has made it more difficult than usual to forecast accurately during this price control review. We also understand that two of the key drivers will be, first, new investments that flow from the Government's environmental policies and programmes and, second, how long it might take for the economic recovery to begin. We also recognise that an important driver of the cost increases is the need to replace distribution assets that are 40 to 50 years old and reaching the end of their lives. But the summarised elements of the forecasts on offer are virtually silent on business justification and how the cost drivers on the businesses are changing.

The pervading sense from the documents is of a quantum shift in the volume of work (asset replacement representing around 25% of DPCR4 outturn) the DNOs propose to carry out mainly on life-cycle grounds compounded by excessive estimates of increased input costs. It is unclear how they have rationalised their proposals on business grounds as there is little accompanying narrative, and we wonder when we will see the summary business plans. We would also expect to see discussion of how they take into account barriers (supply-chain and logistical) of funding any ramp up in investment and the associated costs (as this is already a real issue from the summary of expenditures in the annual cost reports produced by Ofgem), how they integrate their investment programmes with demand-side and other innovative measures and how they have sought to mitigate the proposed costs on consumers through for instance phasing. The recession seems to be pertinent to the DNO forecasts only in increasing financing demands on their business, and they seem to have ignored the strong deflationary pressures in the economy on their input costs and volume estimates, which is not satisfactory. Consumer Focus would have anticipated in the cost forecasts some acknowledgement of the fact that an extended recession should lead to reduced construction costs.

We also note the comments by CEPA in the supporting study published along-side the consultation: "It is a particularly challenging time to make forecasts of input price inflation (nominal and real) and factors affecting electricity demand."[1] It goes on to suggest that in two of its three scenarios real input price inflation is "somewhat below" studies tabled by the industry.[2] It is unclear what result would flow from applying the weights recommended by CEPA, and it would have been helpful to see this developed further within the consultation.

[1] CEPA report, p4
[2] As above, p6.

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For network investment we note that increases due to real price effects including workforce renewal represent around 20% or £611mn of the overall increase in forecast network investment of £3,089mn. We welcome Ofgem's intention (p87) to require the DNOs to provide robust evidence for any real price effects that they are building into their forecasts and to continue to review developments in the wider economy so that a consistent view on this issue can be taken across DNOs.

This issue of over-bidding by the DNOs is highlighted by the fact that some networks are already finding it difficult to spend their capital allowances for DPCR4. It is very likely that, given internal resourcing and external supply issues, they will not be able to spend what they have forecast is needed for DPCR5.

We note that Ofgem has stated it is surprised by the size of forecasts for network reinforcement and input price increases, given current macroeconomic conditions and the contraction in economic output and general deflationary pressure throughout the economy. While Consumer Focus shares Ofgem's surprise, we feel that an important prior step has been omitted or at least is not clear from the documentation, and it is disappointing that the regulator has provided no benchmarks or commentary on what might be more realistic over DPCR5 in the light of prevailing market conditions. In particular we are disappointed that there has been no obvious attempt to rebase the forecasts. Before jumping into methodologies and benchmarking, surely there should be an initial step of establishing what a reasonable set of replacement policies and targets are in the light of the wider business environment and translating these into an appropriate baseline from which to critique the bids.

A feature of this price control review—indeed all recent reviews—has been the significantly increased technical complexity of the challenge process and the methods applied to assess the needs and relative efficiencies of the companies. This trend has been accompanied by fragmentation in the number and complexity of incentive arrangements. In light of this, it is understandable that Ofgem now applies many technically complex techniques and models to different aspects of the network companies' costs and forecasts.

In a number of places Ofgem seeks reassurance on the detailed methodologies and the technical options available to it and its consultants. While we are able to offer some comments, we—and many other stakeholders—are generally not well-placed to offer informed and complete answers. We have no comment on the detail of the methodology—which strays into very technical matters (though we note that the use of multiple years' data from the cost reporting process developed as part of the DPCR4 settlement is likely to improve the robustness of the results). However as a guiding rule the use of such techniques and mechanisms should be seen as a means to an end. The end is to inform a broad judgement on each company, which in turn should draw extensively on Ofgem's relative efficiency analysis but also its wider impressions and experience of the companies.

In considering our response to these proposals, it would have been helpful to have appropriate information on how DNOs are spending on projects to improve interruptions performance.

Customers

Consumer Focus is pleased that Ofgem continues to focus on creating incentives to improve quality of supply and consider this to be an area of major enhancement in regulatory policies during recent years. We also warmly welcome its addressing of equitable arrangements for worst served customers. The proposals in this chapter, while complex, taken as a package seem to have merit.

We welcome Ofgem's stated intention to "define more closely what might be the features of a well- or poorly-performing company" (p10). We are, however, surprised that at this stage in the review it is not clear whether DNOs have or have not included efficiency savings in their FBPQs (paragraph 2.3.1).

We note Ofgem is "considering the extent to which DNOs have undertaken effective customer engagement to inform their business plans and ensure that investment is appropriately targeted" (p9). We hope this is meaningfully followed-up with commentary on how the different companies have performed and that some guidance on good practice emerges from this for future price control reviews and as a feed-in to the RPI-X review at 20. If DNOs do not take on board the views of their customers which have been gathered through the engagement process, Ofgem should require them to give their reasons for this. It would also be helpful if Ofgem could publish the relevant minutes and papers of the Consumer Challenge Group where these are not commercially confidential.

We welcome the new focus on worst-served customers and believe the outline proposals represent a suitable basis for further development, though wonder whether the incentive sum should be reviewed. We agree that a cap should be set on the cost per benefitting customers within the worst served customers mechanism. Without a cap, DNOs could be pressurised by vocal interest groups to divert an unrepresentative amount of resource into a few areas. The majority of worst served customers should not lose out to the few.

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We also welcome the discussion of customers' willingness to pay, but note that the research is now over a year old. Changes in the economy at large and increasing debt levels will likely affect many consumers' willingness and ability to pay. This increases the importance of the findings from the focus groups which are being held in May/June.

Environment

Despite the objectives of the review and the emphasis in previous documents on the environmental agenda, the coverage of such matters in the DNOs' bids and the associated discussion seems very light. The approach on distributed generation looks inadequate and under-powered (p79). The hugely over-generous allowance under DPCR4 suggests too mechanistic an approach based on abstract assumptions should not be pursued for DPCR5. Ofgem notes it "could alter the DNOs' portfolio risk to encourage innovation in new areas that might help meet environmental objectives" (p135), but measures to tackle this are not addressed. Consumer Focus considers that this is a significantly missed opportunity. If Ofgem does not address this, Consumer Focus would question how their new sustainability duty is being interpreted.

Given the importance of this area within the wider policy and regulatory debate, it would seem necessary to have further discussions with the companies, especially in the light of Ofgem's comments that the companies may not have had sufficient time to respond to its outline thinking in the December document. We would have liked to see more consideration of incentives to encourage demand-side initiatives by the DNOs

Given Ofgem's comments about companies' claims about them not being able to afford initiatives and retention of DG specialists during DPCR4, this and the limited detail provided by those that have responded is extremely disappointing. This situation would suggest there is little sign still of a desire to put resources behind this key development area (although a lack of definition of an appropriate incentive scheme has probably not helped).

The DNOs bids for discretionary expenditure for future network flexibility are particularly disappointing and suggest inadequate thought by the companies. Over half of the proposed expenditure is accounted for by one group, and another has made no bid at all.

More generally the companies' apparent lack of appetite in this area is disappointing. We would have liked to see much more specific focus within the review on mechanisms to incentivise local generation and demand-side schemes. At this stage we would also have liked to see more detail on the candidate funding mechanisms.

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We would also have expected to see comment on the effectiveness of the current DG scheme which Ofgem has said it will retain, but which hasn't been very effective. Consumer Focus would support a 'use it or lose it approach' for any incentive mechanisms or funding towards projects aimed at addressing environmental issues.

With regard to the losses incentive, Ofgem says it recognises benefits to the DNOs hybrid solution and proposes to retain the output incentive with an adjustment to take account of loss reductions from allowed investments. As above, three DNO groups failed to provide details of proposed low loss investments, and there is considerable diversity in approaches and the information provided is sketchy at best. Again this is disappointing (though there may be differences in the treatment of loss related expenditure in base case forecasts). In conclusion, we consider that Ofgem should thoroughly review its proposals in this area and consider other ways in which the DNOs can be encouraged to alter their business models to take account of the climate change agenda.

Other key points we would make are:

- We welcome abandonment of the use of **revenue drivers** tied to units and customers and their proposed replacement with investment drivers. It is not possible to determine from the current documentation how such a regime might operate, and considerable further discussion and detail is needed;
- We are concerned that the distributors have significantly over-egged their submissions with regard to **input price uncertainty**, failing systematically to pick up recent reductions in commodity prices. There is a compelling case to permit **indexation** of materials input prices (down as well as up) but only after defined trigger/s have been exceeded, and these should in turn be set at levels that allow managers to exercise their skills and judgement. It is critical that this area of the proposals is revisited near to closure of an agreement so that real price effects are not inflated;
- There is also strong evidence from CEPA that any adjustments to revenues arising from indexation should be carried out through a **logging up system** that takes effect at the next price control so that customers do not face unnecessary increased price volatility within the price control period;
- The **IQI** should ignore real price effects and indexation should be applied through application of an ex-post logging mechanism at the next price control;
- In this context Ofgem is right to emphasise the risks of charge volatility and **predictability of allowed revenues for network users and customers;**

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- The equalisation of incentives on opex and capex is timely and necessary, and our preliminary view is that Ofgem's current proposals––subject to further definition–– strike the right balance;
- We support the strong emphasis being placed by Ofgem on **output measures** throughout the DPCR5 process. Even without the scale of the proposed increases, it is essential that the regulatory settlement is absolutely clear about what customers are to get in return through carefully selected output measures. Our preference would be for output measures to be supplemented by the adoption of monitoring, perhaps through extension of the RRP process or through development of the proposed common reporting template. We also believe that DNOs should be obligated to further develop output measures during DCPR5, especially as Ofgem appears to have doubts about the robustness and completeness of the measures that could form part of this settlement. Any settlement also needs to ensure that the spending is carried out so as to develop and shape the network in the directions dictated by consumer preferences and to meet environmental objectives, but there is little indication at this stage of how such factors might be measured. The initial proposals should set out Ofgem's thinking on these matters. There should also be a thorough and cogent explanation by Ofgem of the allocation of risk between the companies and consumers and the supporting rationale;
- However the overwhelming sense of the documents is that the DNOs proposals with regard to output measure selection are disparate, would not permit suitable benchmarking and are heavily focused on volumetric measures. The tone of the relevant sections of the consultation is that Ofgem is disappointed with progress so far in this area. Ofgem is correct in indicating fall-back strategies in the event agreement cannot be reached, including dilution of IQI incentives.

More generally, as we have noted already, a discernible feature of the practice of price control as it has developed has been fragmentation in the number and complexity of incentive arrangements. In turn, this has made it much harder for non-industry parties to engage in the process. We also wonder if some of this complexity actually might work to the consumer detriment by introducing factors that are easy for DNOs to cost-effectively influence allowing them to increase tariffs for straightforward improvements in service. We would be interested in seeing the justification for some of the quality adjustments to tariff. We also believe there are a number of important issues still to be discussed in the final phase of the review, and would hope that where they might have a material impact on the likely outcomes that there is early exposition

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and discussion of these. If, as appears likely, these are to be "lumped" into the initial or final proposals document, there must be ample time for stakeholders to get to grips with these issues, and certainly more than four weeks, with supporting workshops.

I hope these comments are helpful. My colleague, Abigail Hall, would be pleased to follow them up with you either in person or via telephone (Abigail.hall@consumerfocus.org.uk; 020 7799 7934).

Yours sincerely

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