



Distribution Network Operators,
customers and representatives
and any other interested parties

*Promoting choice and
value for all customers*

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Dear Colleague,

Electricity Distribution Price Control Review – Review of process

On 1 April 2010 the new price control applying to Distribution Network Operators (DNOs) will come into effect. The new price control is the outcome of a two year review process. We are keen to understand stakeholders' views of how the DPCR5 process worked. We would like to build on these experiences when undertaking future price control reviews and use the lessons learned when implementing the findings of RPI-X@20¹, our fundamental review of the approach we take to network regulation.

The purpose of this letter is to seek responses from interested parties on how we conducted the Distribution Price Control Review (DPCR5), with a view to understanding what elements of the review were conducted well, what could be improved and what should be done differently in future reviews.

Please note that it is not the intention of this review to identify whether the policies in the DPCR5 final proposals document were appropriate, as these policy matters have been finalised and were informed by extensive consultation. The focus of this review is on process. Attachment 1 provides an overview of the process we followed during DPCR5.

Interested parties are invited to respond to this consultation. While we welcome views on any relevant issues, Attachment 2 suggests a list of areas for consideration. Responses should be received by 30 March 2010. They should be sent to: **Distribution Price Control, Ofgem, 9 Millbank, London SW1P 3GE**, or DPCR5.reply@ofgem.gov.uk. Unless marked as confidential, all responses will be published by placing them in Ofgem's library or on the website. A short summary of the findings of the review will be published on our website alongside our ideas for how we might take the findings on board.

Any questions on this letter should be directed to Karron Baker who can be contacted on 020 7901 7350 or by email at karron.baker@ofgem.gov.uk

Yours faithfully,

Rachel Fletcher,
Partner, Distribution

¹ [Regulating energy networks for the future: RPI-X@20 Emerging Thinking \(5/10\)](#)

Attachment 1 Overview of DPCR5 process

Objectives and outputs of the review

Ofgem regulates the 14 regional DNOs to protect the interests of present and future consumers. Effective regulation of the distribution networks is important as the 14 DNOs are regional monopolies. Customers rely on Ofgem to regulate them effectively as they cannot, for example, switch their network provider if they do not like the price or service they are offered. We set the total revenues that DNOs can collect from customers at a level that allows an efficient business to finance its activities. We also place incentives on DNOs to innovate and find new ways to improve their efficiency and quality of service. This is achieved through the price control which is set every five years. The current price control expires on 31, March 2010. DPCR5 determined the amount of revenue that may be recovered by a DNO from its customers during the period 1 April 2010 to 31 March 2015.

The process of developing the price control package is important as electricity customers currently pay £3.6bn annually for electricity distribution. This amounts to approximately 15 per cent of an average domestic customers' bill, or around £76 per year. Business customers face a wider range of electricity distribution bills, with smaller businesses paying around £270 per year, medium businesses around £2,000 per year and larger businesses paying as much as £28,000 per year.

In return for the revenue set within the price control, customers expect a reliable supply of electricity and expect their distribution network operator (DNO) to act swiftly to repair faults and respond effectively to complaints, queries and requests for new connections or alterations. Customers also expect DNOs to play a full role in tackling climate change and to consider how they need to adapt to change so that they can continue to provide security of supply into the future.

We formed a number of objectives for DPCR5. These were:

- **Environment-** ensuring the price control gives DNOs strong financial incentives to play a full role in tackling climate change. This meant DPCR5 needed to be flexible enough to accommodate technology change and other opportunities which may arise for DNOs from 2010 and 2015.
- **Customers-** Encouraging the DNOs to respond to the needs of current and future customers, and to strike the appropriate balance between delivering quality of service and managing network costs.
- **Networks-** Incentivising DNOs to invest efficiently so that security of supply is provided at reasonable costs.

DPCR5 accomplished a number of achievements light of the objectives we adopted.

In terms of the environment we recognised that further investment in the electricity distribution networks were required to make the transition to a low carbon economy. We realised distribution networks would need to be able to adapt so they do not prevent the take up of low carbon technologies such as electric vehicles or encourage energy efficiency as smart meters are installed. To this end we introduced a new £500m fund- the Low Carbon Networks fund- to stimulate culture change, innovation and trialling of new technologies, commercial and operating arrangements to enable the DNOs to deliver a low or zero carbon electricity sector.

Key changes were made to enhance incentives on DNOs to improve their customer service. New, tougher standards have been introduced for all stages of the connection process.

More stringent targets for network reliability related to customer's willingness to pay as well as a new broad measure for customer satisfaction have also been introduced.

To ensure the DNOs continue to maintain their networks at reasonable cost, network cost allowances were set 8 per cent lower than the companies asked for- varying by company. The least efficient DNOs saw their allowances reduced by up to 14 per cent.

In addition, a 4.7 per cent vanilla rate of return (4.0 per cent post tax) was set to allow DNOs to fund the costs of debt and equity. This was 25 basis points lower than the cost of capital at the last price control we set for the gas distribution companies. This we considered reasonable as market evidence indicated cost of equity had not risen above its long term average, nor had the financial crisis affected the cost of raising debt.

To help ensure customers requirements were more closely aligned to company objectives new incentives were introduced to allow companies to increase their return on equity (baseline 6.7 per cent post tax), in response to improvements in network efficiency, reliability or customer service. These could enable returns of up to 13 per cent for a shareholder of a company that has improved its performance. At the same time an inefficient company could see return as low as 3 percent and customers will pay lower prices.

To further ensure that the companies still provide a reliable service, clearly defined outputs have been agreed that must be delivered in return for the revenues they collect from customers. This should ensure that the health of the network does not deteriorate and require greater investment and higher prices from customers in the future. Funding was also increased to replace assets installed in the 1950s and 1960s where use of the network is growing.

Consultation process

Each price control review has unique features which must be taken into account when designing the process to be followed. The main features of our consultation process were:

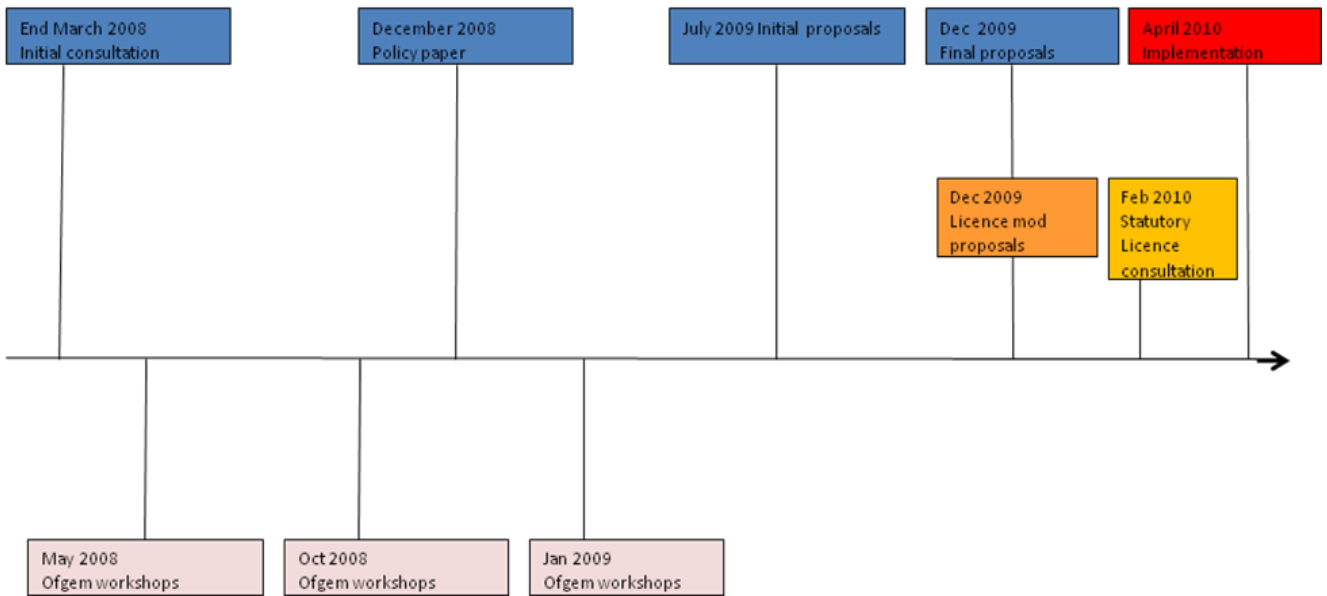
- **Consultation documents.** Over the course of two years, Ofgem issued five key sets of consultation documents: the open letter, initial consultation, policy paper, initial proposals and final proposals. We also issued further documents including the methodology and initial results paper on costs assessments following initial proposals as well as the licence drafting and update documents.
- **Bilateral meetings.** Ofgem met regularly with the DNOs and with other stakeholders including Centrica, Consumer Focus, investors and other interested parties as appropriate.
- **Committee of the Authority meetings.** Senior DNO representatives, the Consumer Challenge group and Centrica met with a committee of the Authority three times during the review period, prior to key decisions being taken. Meetings were held during DPCR5 in October 2008, June 2009 and October 2009.
- **Consumer Challenge Group.** In July 2007 Ofgem set up a panel of six consumer experts whose role was to advise the team on the consumer's perspective of the price control review and act as a "critical friend" in challenging our proposals to ensure we deliver the right package for current and future consumers. Nine meetings were held with the group over duration of the review. In particular they helped refine our proposals on: improving competition and service in connections; environmental measures; customer satisfaction measures; 'use it or lose it' allowance for improving service for worst served customers; and helped introduce network output measures.
- **Working groups with DNOs.** DPCR5 had a number of working groups with DNOs and other stakeholders held throughout the process. Key working groups included the regulatory managers group and groups on environment, customers, connections, financial issues and licence drafting. It is worth noting that other parties were invited to join these working groups where they had a particular contribution to make. These

working groups provided an opportunity for DNOs and Ofgem to consider particular policies and approaches. They did not have any decision making role.

- **Stakeholder Workshops.** Ofgem conducted five workshops to discuss the issues set out in the consultation documents. These seminars were targeted at a broad range of stakeholders, including consumer, industry and City representatives. These were held through the process in May 2008, October 2008 (pensions), January 2009, September 2009 and November 2009 (pensions).

A high level timetable for DPCR5 is provided below.

Figure 1 DPCR5 timeline



Attachment 2 Areas for Consideration

We are interested in your views to understanding what elements of the review were perceived to have been conducted well, what could be improved and what should be done differently in future reviews. We would be particularly keen to receive your views on our process as regards the following areas:

1. In keeping you informed of the DPCR5 process;
2. In making ourselves available to those who had queries or concerns;
3. In writing accessible decision documents that explained the underlying rationale for Final Proposals;
4. In providing an opportunity for you to put your views across and influence the process;
5. In planning the project and setting the timelines for deliverables and responses to consultations etc;
6. In requesting information and the type, form and level of information;
7. In the level of resources we employed throughout to deliver the project;
8. In the number type and form of meetings, working groups and workshops; and
9. In issues that may arise in light of our process in regards to implementing the finding of the RPI-X@20 project.

The areas above are intended as a guide to the types of issue that interested parties may wish to address in their response. Feedback on other areas related to process would be welcome.