Central Networks
Pegasus Business Park
Castle Donington
Derbyshire
DE74 2TU
central-networks.co.uk

Jonathan Ashcroft
T 02476 185766

jonathan.ashcroft@central-networks.co.uk

Hannah Nixon
Partner Regulatory Review
Ofgem
9 Millbank
London
SW1P 3GE

Tuesday 22nd June 2010

RPI-X@20 – Benchmarking & Output Measures

Dear Hannah,

We were very interested to read the papers written by Frontier Economics that consider how benchmarking and output measures should form part of future regulatory frameworks. Frontier Economics have clearly considered these subjects in some depth with a rigorous approach that builds up their proposals from first principles and acknowledges the potential pitfalls of the various options. We are broadly very supportive of the conclusions from these papers and include our response to the key issues below.

Benchmarking
We agree with the general assessment that, for distribution networks, we are entering a period of rapid change such that historic costs may be a less useful guide to future costs. Therefore we support the idea of benchmarking forward looking plans and using the benchmarking of current costs to stimulate questions, rather than directly set allowances. We concur that business support costs are different in nature and that it is still appropriate to benchmark and set allowances for these based on recent costs.

We concur there is value in considering both Opex and Capex together to capture trade-offs and reporting differences. However, as recognised in the paper, there must be consideration of the different drivers and outputs that are being delivered by the forward looking plans. For example if DNO A is looking to make significant improvements to the Health Index whereas DNO B intends to maintain its value, potentially due to higher previous investment, at a lower level, then we might expect different levels of capital work in their plans which does not necessarily reflect inefficiency.

We agree that it may not be possible to specify a model which takes all the output measures into account and that this may need to be simplified by considering the

Central Networks East plc
2366923

Central Networks West plc
3600574

Central Networks Services Limited

Registered Office:
Westwood Way
Westwood Business Park
Coventry CV4 8LG

E.ON Central Networks

financial impact associated with some outputs. It is certainly true that some of the output measures are associated with less financial spend than others. E.g. the customer satisfaction measure will be associated with less spend than heath or load indices.

In the case of network performance, the rate of change or deterioration would mean it may be too simplistic to use the CML/CI penalty value for network performance, and perhaps the value should reflect the input costs to reduce CML / CI as a more relevant measure.

We believe there is also a potential impact from previous investment on the future plans and current operating costs of a network. We agree that there are some issues around the RAV as a measure of previous investment. However we believe that a long term Capex average measure could be derived from existing Ofgem values as we proposed for DR5. If such a measure can't be determined then there may be a way to incorporate the DNOs current Health Index position as an explanatory variable for costs. E.g. a DNO with healthier assets (as a result of previous investment) may expect to have lower operating costs through lower costs for faults, I&M and asset replacement.

We share the concerns expressed over the appropriateness of equalising cost incentives between high level cost categories to avoid boundary issues and then focussing on bottom up benchmarks which impose very strict cost boundaries.

Similarly we also have concerns over the use of the "assets causing man hours of work" driver that was used in the DR5 benchmarking. This suggested that one of our DNOs required 1.4 times as many manhours of work than the other. However, applying our policies equally to our DNOs indicates that the DNO required 1.1 times more work. This suggests that the manhours work metric does not reflect our policies and this will distort our efficiency scores. While the manhours of work is a better driver conceptually, we must be certain that we can determine the manhours of work for each asset type that represents an efficient value. The analysis behind this metric was complicated and while there was an attempt to combine data from the DNOs to create this, there was significant opportunity for this to be distorted by different interpretations of work content. Unfortunately Ofgem's calculation was not shared and it is not clear whether the variations in the values for each DNO undermine the appropriateness of this metric.

We also share the concern expressed in the paper about cherry picking from a set of unit costs and this was a problem with the approach used for Capex unit cost benchmarking that was not completely mitigated by using median costs as a benchmark.

Finally, we agree that the level of complexity in the DPCR5 benchmarking should not be repeated. We think that using a model network would result in even higher complexity

and support the assessment in the paper that this would result in a "battle of the models" which would not necessarily move the industry forward. Whilst a model may determine the current efficiency, we should not lose sight of the fact that customers will benefit most through a transparent approach which encourages companies to continue to challenge their relative performance within a price control.

Outputs

Once again it is clear that the subject matter has been given thorough consideration which has tried to assess all the potential options and the possible unintended consequences. There is much in Frontier Economics' report that we can support.

Firstly, we agree that the broad categories for output measures should be:

- Environment
- Reliability
- Safety
- New Connections
- Customer Satisfaction
- Social Obligations

Secondly, the paper identifies several areas where the calculations around output measures cannot be so definitive as to enable a mechanistic treatment, the interactions between some output measures and the negative consequences which would be likely to occur if DNOs were penalised for modest "under-performance". We agree with these assertions and believe it is likely that policy differences and circumstantial impacts could limit the validity of some output measure comparisons. The paper presents the option of representing CMLs and CIs, our best understood and longest established measures, in forward looking benchmarking as an input cost. While the theoretical arguments are appealing, there are the practical problems undermining the robustness of comparative assessment using CMLs and CIs. These are that CMLs and CIs may be slow to respond to a lack of investment and that weather impacts are not entirely normalised by the exceptional event mechanism. Our concern is that once converted into pounds and added together with the actual costs, the CML/CI value will be treated with all the certainty of the cost information rather than an indicator with a degree of uncertainty around it.

The paper also correctly identifies some of the potential difficulties in defining an aggregate measure for network risk when not all approaches to risk management lend themselves to quantification and that a tier 1 measure that can be incentivised is not likely to be gained from the aggregate of tier 2 measures.

Given the large degree of uncertainty around the future levels of network investment required to cater for increased distributed generation and the uptake of heat pumps and electric vehicles, we strongly agree with the emphasis in the paper on developing a workable legitimisation process for investment ahead of need. We agree that such a process is required to enable timely investment therefore avoid insufficient capacity, while providing a sense check to avoid "gold plating". Given the scale and importance of the changes to facilitate a low carbon energy sector it is vital that network regulation is not a barrier to future change.

We agree with most of the proposed output measures and incentive mechanisms put forward in table 2 of the executive summary. The proposal for marginal incentives around the business carbon footprint is qualified as being "only when this becomes appropriate." The appropriateness of marginal incentives may not only be dependent on gaining sufficient experience of the reporting mechanism to consider it robust, but also on finding the appropriate normalisations to account for the factors likely to affect the carbon footprint. Table 2 also suggests that losses may be incentivised by the application of guaranteed standards as well as a marginal incentive. Given that guaranteed standards are generally paid to an individual in respect of a known instance where service fell below an expected standard, it is unlikely that this would be an appropriate mechanism to apply to losses.

Summary

We believe both the papers by Frontier Economics have been useful in identifying the key issues in their respective subject areas. We believe that the shift to benchmarking future costs, backed up with some benchmarking of current costs for comparison is a sensible approach given the anticipated changes to nature of networks themselves and therefore their operating costs.

We support the assessment of output measures as part of the evaluation of business plans but believe that the output measures may not lend themselves to direct benchmarking. This is not simply due to the differences of interpretation that occur when new measures are introduced, but will reflect differences in policy or approach which will always reduce the comparability.

We strongly support the need to develop a process to enable investment ahead of need. This is likely to deliver greater benefits to the customer than developing tighter control processes around long standing elements of the regulatory framework.

If you have any further questions relating to the contents of this letter, please don't hesitate to contact me.

Central Networks East plc
2366923

Central Networks West plc
3600574

Central Networks Services Limited

Registered Office:
Westwood Way
Westwood Business Park
Coventry CV4 8LG

Yours sincerely

Jonathan Ashcroft
Regulation and Commercial Manager