

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

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Dear Hannah

### **RPI-X@20 report: The future role of benchmarking in regulatory reviews**

Thank you for publishing this Frontier Economics report and thus providing the opportunity to provide further views on your current thinking regarding benchmarking as part of the regulatory review. I can confirm that our response is non confidential and can be placed on the Ofgem website.

There can be little question that the electricity distribution sector faces an extended period of increased uncertainty as it adapts to the requirements of a low-carbon society. This will be a time of change and DNOs will need to become more agile and innovative in responding to this. In that context it is appropriate that the balance of price control discussions shifts to a greater consideration of future requirements, informed by strong stakeholder input. A largely mechanistic approach which extrapolates historic cost performance will no longer provide clear guidance as to expenditure going-forward.

In our response to the RPI-X@20 emerging thinking consultation, we observed that a move to total cost benchmarking was the logical conclusion of equalising incentives on Opex and Capex. We also concluded that the strong emphasis on historic cost benchmarking would be of less value in an environment where networks companies are responding to differing stakeholder requirements and hence outputs will have started to diverge. We are encouraged that Ofgem recognises some of these important implications, and hence has commissioned this detailed report from Frontier Economics. We endorse the recommendations and much of the analysis presented.

The paper is correct to recognise that there are inherent differences between Networks Companies, which historically may have been masked by inefficiency. As these inefficiencies have been addressed, factors, such as the different mixes and scales of operational activities, the operating environment, differing input prices etc., become much more significant. In DPCR5, adjustments were made ultimately to recognise these factors, however considerable time was devoted to their definition and calibration. We believe it is an important step that an independent report of this sort has unambiguously acknowledged the need to recognise such items.

We are also in agreement with the suggested structure of the business plan whereby a company will present a base scenario, supplemented by a range of costed options, reflecting enhanced outputs, and different delivery options in respect of mix and timing. As these options will have been tested and evidenced through ongoing stakeholder engagement, this should provide an excellent basis for discussion between Ofgem and the Networks Company.

Whilst considering issues of benchmarking in detail, it is important to remember that it is merely one piece in an integrated regulatory framework, and these elements will need to be consistent and mutually supportive. The paper argues that a price-control period of 5 years is an appropriate choice for benchmarking purposes, and we would agree with the arguments for this. Likewise it is proposed that capital consumption is used in the calculation of total cost. Clearly this needs to be reflected upon when the issue of regulatory depreciation periods is considered.

We have included more detailed comments on the issues raised in the report in the attached appendix. If you have any questions on the points raised in this letter, please do not hesitate to contact me.

We hope that you find this submission helpful.

Yours sincerely

Paul Delamare  
DPCR5 Programme Director

## Appendix 1 :

### Detailed comments on RPI-X@20 paper: *The future role of benchmarking in regulatory reviews*

#### Challenges facing benchmarking

There can be little argument with the rationale behind benchmarking of historic costs and it is clear that it has proved a powerful incentive to cost efficiency in the twenty years since privatisation. However, in the light of the uncertainty facing this industry, the paper is correct to weigh up the pros and cons in an objective manner.

The paper is right to argue that there is a need to minimise distortions that may arise through different treatments of individual cost types, and hence concludes that this is best achieved through applying both the same incentive mechanisms but also similar, and ideally identical, benchmarking methods.

The paper then makes the crucial point that “No two networks businesses are exactly the same”. It goes on to identify a number of underlying differences, which are not efficiency-related, including input costs, operating environment, past configuration and planning decisions, which will result in differences in costs between Network Operators.

At DPCR5, Ofgem made a significant step in recognising the existence of such factors through its application of regional labour and contractor cost and urbanity/sparsity adjustments.

A regulatory framework which is driven by stakeholder need, and realised through a commitment to deliver a specific set of outputs will only accentuate the differences between the Network Operators. It is our belief that this should result in more bespoke price control agreements between Ofgem and each of the companies.

Frontier Economics poses a question regarding the use of outputs in benchmarking and whether these could be built into the statistical models. At DPCR5, the development of drivers which represented activity or achievement proved difficult, resulting in the use of measures of cost, as a proxy. The use of an output measure as a driver is an interesting proposal, and we would recommend that Ofgem considers this in greater detail to see if a workable model can be arrived at.

The paper is correct to step back and consider the context in which benchmarking takes place. It is right to recognise the inherent uncertainty in the nature and timing of moves to a low-carbon economy. Equally it notes that this will require a framework which encourages both innovation and timely action. What is certain is that there is likely to be a substantial increase in expenditure over the coming years, although the timing and mix of this expenditure is unclear.

In our opinion, this context leads you to conclude that past costs are likely to be a less accurate guide to future expenditure levels. This is not to say that they do not have a role in sense-checking

the underlying unit or process costs, but the emphasis in a price-control should be on detailed consideration of future plans rather than an ex-post assessment of performance.

### **Use of Total Cost for benchmarking**

The primary purpose of the equalisation of incentives on opex and capex is to incentivise companies to make efficient choices between opex and capex-based solutions rather than be sidetracked by decisions over whether opex or capex spending might be more financially advantageous. We would wholly endorse Frontier Economics conclusion that this inevitably leads to a requirement that benchmarking also takes account of these trade-offs.

The challenge with total cost benchmarking has always been how the capex element is arrived at. In proposing two possible formulations, namely planned opex + capital consumption and planned opex + planned capex, the paper adopts a pragmatic approach.

The paper correctly points out the 'lumpiness' of capital expenditure and hence we would suggest that the use of a rolling average value for capex might be appropriate. Ideally one would opt for the longest-possible period to measure this against, and it may be necessary to include some forecast years to adequately encompass a full investment cycle. Whilst using forecast data brings a degree of risk, this should be contained as long as the number of historic years significantly outweighs the forecast years. Also, we would echo the point that benchmarking should be used to test the assumptions underpinning the business plan rather than as a means to arrive mechanistically at expenditure allowances.

It should also be noted that the debate regarding regulatory depreciation could have a material impact on the calculation of Capital Consumption. Hence we would request that Ofgem takes full account of this potential knock-on effect when it considers its final position on this issue.

### **Benchmarking of Business Support Costs**

The paper suggests that Business Support Costs are more suited to a traditional cost benchmarking approach than the Closely Related Indirects. Whilst one can make an argument to that effect, Ofgem needs to recognise the practical consequences, namely the requirement to arrive at an appropriate set of Cost Drivers.

At DPCR5, a combination of MEAV and Direct Costs was used as the primary driver. It is our opinion that this was not a rational choice of driver. It is difficult to see what the relationship is between HR or Finance spend and the value of the physical assets. This set of costs are much more closely driven by factors such as levels of activity, for example, a large Connections business will inevitably result in a requirement for additional Finance resource. Likewise, a workforce which is spread over a large geography will require a more distributed, and hence probably more numerous HR support.

We also believe that benchmarking can not simply be a mechanical process. In the same way that you are recognising that there is a need for discussion between Ofgem and each DNO on future plans, we would also suggest that a qualitative assessment of spending on Business Support can also add considerable value.

The expert review of Property Management costs, carried out by Drivers Jonas, as part of DPCR5, was from our perspective an extremely useful exercise. It provided a constructive critique of our Property strategy and identified clear opportunities within our Property costs, as well as highlighting those areas where we are performing well.

On the basis of this experience, we would strongly encourage the extension of expert review into the other categories of Business Support cost. It is our view that such an approach offers no lesser scrutiny of the efficiency of this expenditure but will ensure that this assessment reflects the particular situation of each DNO. It also brings the significant benefit of an insight into best practice, not just from within electricity distribution, but the wider business environment.

### **Candidate Methodology – Total Cost Benchmarking**

Frontier Economics puts forward an approach based on Total Cost Benchmarking as one of its four candidate methodologies and ultimately recommends this approach for Electricity Distribution.

As discussed previously, it proposes two alternative measures of total cost and is correct to recognise that these have both merits and drawbacks. However we would suggest that these are pragmatic choices.

We support the arguments in favour of a 'top-down' model. We endorse the view that it is the responsibility of management in the Networks Companies to utilise the total finances available to them to operate their businesses as efficiently as possible, and it is not the role of the regulator to seek to micro-manage. However, it should be acknowledged that more disaggregated models do play a useful role by providing insight into those areas of activity where relative inefficiency can be observed. Whilst supporting an approach which majors on the 'top-down', it would be sensible to retain access to more disaggregated analysis as a means to facilitate continuing improvements in efficiency

The paper recommends a move away from some of the 'work' cost drivers, which were employed at DPCR5, but which were in reality a subset of costs. It proposes alternatives such as numbers of connections, peak load etc. It is our opinion that the types of explanatory variables proposed is more reflective of the cost drivers of a networks business, however whilst supporting these changes, the work required to develop and test these drivers should not be underestimated.

The paper discusses the use of Model Network Analysis as a means of capturing exogenous differences in operating environment. We would support this as a subject worthy of further discussion, however, like the paper, we would be wary of the potential resource requirements of realising such an approach.

Equally we believe that the suggestion that output variables might be included within the statistical model, either in a monetised form, as part of the total cost, or as an explanatory variable is worthy of serious consideration.

We would have some concerns with their use as part of the total cost, as there is the potential that companies could be rewarded/penalised twice where the output is incentivised in some way, i.e. once through the operation of the incentive mechanism and a second time through the impact on benchmarking. Intuitively, incorporating outputs in to the explanatory variable might be more effective as it would enable a meaningful comparison between different networks companies which have chosen to target different levels of performance of the same output through different levels of expenditure.

Irrespective of our concerns, use of output variables in benchmarking is an interesting avenue to explore and we look forward to seeing further and more detailed thoughts from Ofgem as to how it might be realised.

The paper makes reference to a possible structure for future business plans. In essence it suggests a base scenario with a range of scenario-based costed options. These options would consider both enhancements to the proposed outputs but also differences in timing of their delivery. This approach, based on the use of scenarios, very much reflects our own views, and we would suggest will fit neatly with the desire for much greater stakeholder involvement in the development plans

We also note that Frontier Economics recommends a five-year period for the forecast business plans. This is a position that we would support also, although we would suggest that a more appropriate position would be a 5-year fully detailed business plan in the context of a longer term development plan.

## **Recommendations**

The paper settles on an approach based on the benchmarking of future plans at a total cost level. Whilst it sees many merits in the use of TFP, we would agree that this technique may be more suited to a time of greater stability.

We agree with the shift in emphasis on the use of historic costs, such that they will form more of a cross-check on future planning assumptions, rather than a mechanistic determinant of future allowances.

We also agree that there is a continued role for incentives for efficient and effective forecasting, such as the IQI mechanism. However, it should be said that IQI itself will need to be developed further to recognise an environment in which the networks company will be presenting a range of scenarios, and stakeholder requirements will have much greater weight.