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Dear Rachel,

**Electricity Distribution Price Control Review – Review of process**

Thank you for giving us the opportunity to comment on your publication *Electricity Distribution Price Control Review – Review of process*. Our full response is attached.

Should you wish to discuss any of the points raised in this response in more detail we will be happy to do so at your convenience.

Yours sincerely

**John France**  
**Regulation Director**

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW**

**REVIEW OF PROCESS CONSULTATION**

**THE RESPONSE FROM CE ELECTRIC UK FUNDING COMPANY  
(CE), NORTHERN ELECTRIC DISTRIBUTION LIMITED (NEDL)  
AND**

**YORKSHIRE ELECTRICITY DISTRIBUTION PLC (YEDL)**

**30 March 2010**

Thank you for giving us the opportunity to comment on the process that Ofgem applied to the fifth Electricity Distribution Price Control Review (DPCR5). We continue to appreciate Ofgem's endeavours to improve the process.

In summary, we welcomed the opportunities for interaction and discussion with Ofgem. In particular, we valued the formally scheduled bilateral meetings with Ofgem's team and the Authority. On cost assessment, Ofgem was transparent and open to interaction and scrutiny of its benchmarking activity such that we were able to usefully engage in meaningful dialogue. However, the key decisions on cost of capital and the profile of the cashflows should have been exposed to more open discussion earlier in the process in order to avoid introducing uncertainty towards the end of the review. The suggestion that Ofgem was approaching the subject of pensions without being constrained by the statements made at DPCR4 was also unhelpful as it undermined investors' confidence in the commitments given by Ofgem at price control reviews. In the end Ofgem honoured its prior commitments in this respect and this has done something to repair the damage. However, the introduction of this uncertainty was completely unnecessary and served no useful purpose. In future we hope that Ofgem will take care to reinforce, rather than to cast doubt upon, its prior commitments. This would diminish investors' perception of regulatory risk which would ultimately reflect itself in the prices that customers pay.

Ofgem's open letter invites views on the process of the review and suggests nine areas for consideration. In the comments that follow in this response we address all but one of these areas with what we believe to be the most material and useful observations relating to the key topics in the review. With respect to the resources employed (Ofgem's area number seven), we have not answered this specific to each issue. Rather we would suggest that, from our vantage point, the project seemed to be sufficiently resourced. It is inevitable that a complex project such as this will stretch individuals and teams and there is only so much that can be done by adding to the resources deployed before you create another problem, namely the coordination and management of those resources. We think Ofgem managed this balancing act reasonably well.

The response is structured under the key price control topics of cost assessment and overall process, cost of capital, speed of money, revenue profiling within the DPCR5 period, pensions and tax. In each of these sub-sections we identify which of the Ofgem areas we have considered (from the list of nine in the consultation) and summarise our views in response.

### ***Cost assessment and overall process***

There were several positive aspects to Ofgem's treatment of cost assessment in DPCR5. Ofgem was quite transparent in the application of its cost assessment methods. Moreover, Ofgem was particularly impressive in its openness to new thinking, its appetite for uncovering a truer picture of efficiency and in its general responsiveness to answering our questions about its modelling and the data inputs that were being used. We welcomed these aspects of the review.

Turning to areas for improvement, Ofgem's timetable remained fluid throughout the review process which made it more difficult to plan for key interactions and consultations. We think it would have been beneficial if Ofgem had created more certainty in its milestones for the review in order to enhance the quality of the engagement with companies. We said from the start of the review that formal update proposals would have been useful in order to provide a latest minded to position to accompany final interactions with the Authority in October 2009. Instead, at DPCR5, there were cost update publications in September and October 2009 focused on correcting and finalising cost assessment, with additional side-letters on various sub-topics. This final flurry of activity generally occurred with little or no pre-warning and very tight timescales for the return of data and views. We believe that these highly significant interactions should have been set out in a more measured, open

and scheduled manner. It is reasonable to expect clearer signals as to the phases and milestones of these important steps in the review process. We maintain that Ofgem should reconsider and make use of update proposals at subsequent reviews since the experience at DPCR5 has simply served to reinforce our view that they are essential.

Our views on cost assessment and overall process are relevant to areas one to six, and eight, as set out by Ofgem in its open letter. In summary, we believe that Ofgem could have set out the process more explicitly (area five). For the relatively fluid process that existed, companies were kept reasonably informed with the exception of the autumn 2009 cost updates where it was not clear what documents would be available at what time (area one). We believe that Ofgem did well at providing accessible decision documents for cost assessment (area three) with the important exception that a formal set of update proposals should have replaced the numerous autumn updates.

For area two, Ofgem did very well at making itself available to answer queries and to discuss concerns and, generally, there were good opportunities for us to put our views across and influence the process (area four). We found that this was true on both a formal basis (bilaterals and meetings with the Authority) as well as on an informal basis (with individual members of staff and senior management). Further, we believe that the number and type of meetings, working groups and workshops were appropriate (area eight). Lastly, we believe that the level of information requested by Ofgem seemed appropriate (area six).

### ***Cost of capital***

The determination of the weighted average cost of capital (WACC) was one of the defining aspects of this price control review, due to the unprecedented nature of the financial environment and the innovative return on regulatory equity (RORE) approach that Ofgem adopted. With respect to process, the absence of an opportunity to discuss a quantified Ofgem view on cost of capital prior to the *Final proposals* was unhelpful. RORE was discussed only in conceptual terms until the very end of the review which made it difficult for us to engage with Ofgem on this matter in any meaningful way. We, and others, may have been slow to pick up on the implications of RORE for the underlying WACC, but we do not agree that the volatility of market data excuses the absence of a serious opportunity to discuss Ofgem's intentions with the Authority.

To be clear, we are commenting here on the visibility and openness of Ofgem's working as opposed to the end result itself. This does not mean that we think the answer was appropriate. However, we appreciate that, having accepted the *Final proposals*, the time for commenting on the outcome has passed. If more visibility had been provided of Ofgem's view on the cost of capital, earlier in the process, both to us and to other interested parties (e.g. city analysts), this would have enabled a smoother transition into the DPCR5 period in terms of reviewing our business plans and informing credit ratings agencies. We believe that the investors' perception of regulatory risk, referred to in my opening remarks, has been unhelpfully increased by the process adopted due to the absence of appropriate signals on the likely outcome from the process.

Our thoughts on cost of capital are most relevant to Ofgem's request in its open letter for feedback on the process relating to the writing of accessible decision documents that explained the underlying rationale of its proposals (area three). In summary, we consider that the earlier documents were remiss in not setting out a documented Ofgem view on cost of capital.

### ***Speed of money***

In contrast to cost of capital, for speed of money Ofgem's process did provide an indicative figure at the *Initial proposals* stage. So engagement between companies and Ofgem was possible. CE was active at an early stage and we introduced some economic thinking into the debate, arguing that the speed of money established at DPCR4 remained appropriate. Ofgem was initially receptive to these arguments, stating in the *Initial proposals* its intent to maintain a similar proportion of capitalisation of costs as at DPCR4 in relation to *network costs*. In effect, the commitment meant that the RAV additions percentage (or slow cost recovery) applying to network costs should be set to ensure that a similar proportion of these costs were expected to be capitalised during DPCR5 as if Ofgem had applied the RAV addition rules used in DPCR4. However, in the *Final proposals*, Ofgem changed its position and stated that its aim was now broadly to maintain the same speed of money as at DPCR4 *including allowance for pensions deficit repair*. This change in scope was highly material.

We believe that Ofgem should not have changed its position later in the process following the commitments it made in the *Initial proposals*. Again this had a detrimental impact on investors' perception of regulatory risk.

This issue is again most pertinent to Ofgem's request for feedback concerning the process relating to the writing of accessible decision documents that explained the underlying rationale of its proposals (area three). It is also of relevance to the long-term implications associated with implementation of the RPI-X@20 project (area nine). Put simply, we think that Ofgem should try to avoid resiling from positions set out in *Initial proposals* because this has implications for the longer term in respect of confidence in the regulatory regime.

### ***Revenue profiling within the DPCR5 period***

Prior to the *Final proposals*, Ofgem's thinking on the profiling of revenues was documented in the *Initial proposals*. Although we accept that the words used in the *Initial proposals* did not absolutely rule out the so-called smoothed approach that was taken in the *Final proposals*, the failure to signal the move to smoothed price increases caused a major disruption in our relations with our shareholder. This, along with the lack of signalling regarding the cost of capital and RORE implications, our misplaced confidence that Ofgem would not finalise the overall speed at which network expenditures would be remunerated at 85/15 and the change in the approach to revenue profiling have diminished the confidence of investors in the UK's regulatory regime. In addition to the avoidable disruption, if the process had allowed for discussion on this highly material earnings gap (*ca.* £40m for CE in 2010), a consultation might have produced a different answer. As it was, this option was unavailable since dialogue was precluded by the process. Furthermore, Ofgem's failure to discuss these plans led to its failure to take account of prior commitments given in respect of the recovery of the DPCR4 re-opener expenditures which had to be corrected after the publication of the *Final proposals*. This could have been avoided if Ofgem had been prepared to share its thinking on revenue profiling before the *Final proposals* were developed.

Consultation with stakeholders was an important new feature at DPCR5. Towards the end of the process Ofgem was keen for companies to communicate with suppliers so that notice was provided of likely price changes. We planned and entered into discussions with suppliers to take account of this communication need. The late changes made to the profiling of revenues meant that suppliers were not presented with an accurate picture of prices until after the *Final proposals* had been fully assessed in December 2009. This accurate view was markedly different from the earlier information provided due to the late change of policy by Ofgem.

For this topic, our criticisms centre on Ofgem precluding our opportunity to put our views across due to the late nature of its considerations on revenue profiling (area four).

### ***Pensions***

With respect to pensions, Ofgem introduced unnecessary uncertainty when it appeared to be willing to resile from the commitment made, in appendix one of the DPCR4 *Final proposals*, to maintain the principles in subsequent price control reviews. The root and branch review of the pensions principles for all regulated networks sectors, conducted concurrently with DPCR5, should have made clear at the outset that these principles would be honoured and might usefully have made clear that the legislative constraints imposed by the protected persons regulations were, and would continue to be, a major constraint on companies and, therefore, upon customers. At first Ofgem showed itself to be too credulous with respect to the rather vague claims made by Centrica about the opportunities that existed for DNOs to reduce their pension liabilities. We consider that Ofgem's process should have allowed for more due diligence before it raised the prospect of possible pensions treatments that could easily have been ruled out by a little more thought at that stage; this would have enabled the constraints on its policy making to be taken into account before a misleading impression was given to stakeholders about the possibilities at the review. The mishandling of the pensions issue increased investors' perception of risk quite unnecessarily.

We believe this is primarily a learning point in respect of implementing the outcomes of the RPI-X@20 project for future price control reviews (area nine).

### ***Tax***

Our ultimate shareholders pay close attention to how the regime treats us in respect of tax, pensions and cost of capital. They regard those items as strong indicators of the reasonableness of any regime in which we operate assets. Our shareholders can understand a regime that incentivises companies to minimise the costs over which it has control, but they were dismayed by Ofgem's interpretation of some admittedly unclear wording in the DPCR4 settlement that left us out of pocket by over £40m on our unavoidable tax liabilities in that period. This seemed to our shareholder to be a questionable regulatory judgement and to reflect badly on the regime in general.

For the avoidance of doubt, I should say that we entirely accept the outcome of this and every other aspect of the DPCR5 proposals that we have accepted. We mention the issue in order to register the point that our shareholder looks for long-term fairness in the regime while also accepting the feature of the UK regulatory framework that firm deals are made at price control reviews. Combining these two points, our shareholder then expects Ofgem and the management of the company to reach a balanced outcome that reconciles both these objectives. We do not say that the outcome for tax is manifestly inconsistent with the words of the DPCR4 *Final proposals*; but another solution was available to Ofgem, that was also in line with the words used at DPCR4, and would have provided an outcome that enabled an efficient company to recover its costs.

As with our previous point on pensions this issue on treatment of tax at DPCR5 is primarily a learning point in respect of implementing the outcomes of the RPI-X@20 project for future price control reviews (area nine).

***Concluding remarks***

In closing, it is appropriate to acknowledge that, while noting what we considered to be strengths in the DPCR5 process, we have naturally tended to concentrate on the material issues where we think that the process could have gone better. On balance, therefore, Ofgem should not conclude from the criticisms included above that we believe DPCR5 was a badly conducted review. On the contrary, we believe that there were many aspects of the review that improved on previous practice. In particular, Ofgem was quite transparent in the application of its cost assessment methodology, demonstrating an appetite for uncovering a truer picture of efficiency and in its general openness to dialogue on the process and results. We very much appreciate this approach to the review; we do not take it for granted and we extend our thanks to the team who showed this commitment through an extended period of intense pressure. For our part, we remain committed to engaging openly and positively with Ofgem on continuing and future projects.