



Network owners, suppliers,
customers and other interested
parties.

*Promoting choice and value for
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Dear Colleague,

RE: Electricity Distribution Price Control – Review of process

On the 1 April 2010 the new price control applying to Distribution Network Operators (DNOs) came into effect. This was the outcome of a two year price control review (DPCR5) process. We were keen to understand stakeholders' views of how the DPCR5 process worked and on the 2 March 2010 we issued an open letter consultation seeking their views. The purpose of this consultation was to build on these experiences when undertaking future price control reviews and use the lessons learned when implementing the findings of RPI-X@20, our fundamental review of network regulation.

We would like to thank all those stakeholders who responded to our consultation. A copy of the responses to our consultation can be found on our website. The purpose of this letter is to provide an overview of the feedback we have received and outline how we plan to incorporate this into future reviews.

In our open letter consultation we sought the views of interested parties on how we conducted 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.

From the responses received and feedback from our DPCR5 team we have identified a number of areas of good practice we would like to build on, but also some areas we intend to do differently.

The majority of respondents who participated in our review considered that DPCR5 was a professionally run price control review process which represented an improvement on previous reviews. Benefitting from the lessons learned from other reviews, we were able to provide external stakeholders with the information and access they required from us, while ensuring we made good use of the expertise and time of internal decision makers. We managed the team and our consultants well allowing us to meet deadlines and produce high quality analysis and written work. More specific areas of good practice are set out below.

A committed and accessible DPCR5 team

External stakeholders, including DNOs welcomed the effort the DPCR5 team made to ensure they were available to discuss aspects of the price control. Also, the effort the price control team demonstrated in working to deadlines to ensure delivery provided external parties confidence that the programme was running to schedule. Based on the lessons

learnt from previous price control reviews we made less use of consultants. This meant the team was able to handle detailed queries across the breadth of the project scope.

An informed and engaged Committee of the Authority

The DNOs welcomed the time spent with the Committee of the Authority to present their views. They appreciated the opportunity to have direct access to the decision makers and found the Committee members engaged and well briefed.

Strong project management

We had a stand alone and well qualified project management team. This was vital to the timely delivery of the project, provided a focal point for the team and made sure there was sufficient time for us to produce well written documents.

Attention to quality of documents

Consultation documents and internal briefing documents were of a high quality according to respondents. The majority of respondents welcomed the change in format to the main document, which provided an overview of the key themes in the review, with supplementary documents providing technical detail on our analysis and recommendations. The addition of a document that provides an overview of what is provided in each of the documents would have been welcomed by some respondents.

Well structured external engagement

DNOs and other external stakeholders found the process of workshops between consultation documents useful in order to inform and provide early exposure to our thinking. DNOs also welcomed the time spent in bilateral meetings with senior members of the team and working groups established to help develop proposals. Other external stakeholders welcomed the increased focus on consumer interests in the review and time spent on these in working groups. There is appetite from some parties for further stakeholder engagement which we will incorporate into the next reviews to reflect the recommendations from the RPI-X@20 project.

Other

Other areas of good practice we have identified are; the use of a secure internet based data collection method (extranet); the increased level and detail of information used for analysis; and the early start we made to licence drafting which helped in achieving a fully amended licence by 1 April this year. We may seek to build on this as part of our RPI-X@20 recommendations by requiring the network companies to develop licence modifications earlier in the process.

Improvements to be incorporated into the next price control reviews

Our review sought to identify specific areas where the process could be further improved. These have been noted and we are already implementing these recommendations as part of our preparations for the forthcoming gas distribution and transmission price control reviews. The key improvements are set out below.

Bringing the network companies with us

The DPCR5 process demonstrated that we need to build in time to ensure the network companies (and other stakeholders) understand fully where our thinking or approach to key issues has changed, and the implications of these changes. In DPCR5 we used Return on Regulated Equity (RORE) analysis for the first time. While this analysis was trailed early in

the process (December 2008), it was clear that DNOs did not understand how we sought to apply this analysis until the end of the price control review.

The next price control reviews will apply the principles to be agreed through the RPI-X@20 project. While this project is yet to conclude, it could signal a significant change to the normal price control approach. We are starting to talk to the network companies now about GDPCR2 and TPCR5 in an attempt to avoid any misunderstanding. We will be setting out our proposed approach and highlighting the key changes in an open letter to stakeholders at the end of this month.

Senior input to the price control review

There was general agreement in the DPCR5 team that the review process would have run more smoothly if the senior team members in particular were able to dedicate more of their time to the price control review.

Two new band E roles have been created to manage the GDPCR2 and TPCR5 price control processes. Individuals appointed to these roles will be responsible for managing the workloads and interactions between the different teams involved in each price control. They will work together to ensure that we take a consistent approach across the two reviews and use resources appropriately. Creating more depth in the team

The review showed that we could have done more to reduce our reliance on a handful of individuals in the team and there is a recognition that the project would have been at risk if any of these had left or fallen ill during the review.

We are taking steps to ensure that knowledge and skills are more widely spread within the teams to reduce pinch points around the availability of key members of staff. For example, the Regulatory Finance team are taking steps to ensure that knowledge around pensions and tax is spread more widely than at DPCR5. We are also building up more specialist benchmarking skills.

Earlier discussion on Cost of Capital

The key criticism from DNOs was that our position on WACC came too late in the process and did not give them sufficient time to engage on cost of capital issues, particularly with the Authority Committee.

While we still consider there were good reasons for not announcing a range of WACC in Initial Proposals, we are planning to start discussions over WACC and other elements of the financial methodology much earlier in the process for both GDPCR2 and TPCR5. This could be as early as March 2011. In particular, the early documents in these reviews will set out a clear methodology for the cost of debt which will give an indicative range for that component of the cost of capital.

Earlier conclusion of cost assessment

Discussions on our view of efficient costs continued far into the DPCR5 process, with DNOs presenting revised data late in the day and in some cases, raising cost assessment methodology issues in the last round of discussions with the Authority Committee. This represented a shift from our plan to have resolved most cost allowance shortly after Initial Proposals and may have distracted debate from other important issues (such as cost of capital etc).

As part of GDPCR2 and TPCR5 we plan to set out both earlier, and in greater detail the cost assessment methodologies (ideally as early as December 2010 with more detail to follow in March next year). We also intend to set a clear cut off point beyond which the companies will not be allowed to revise their business plan bids.

Development of reporting arrangements

We formally finished the DPCR5 process at the end of May with the publication of instructions to DNOs on the data they must provide to us on an annual basis to allow us to monitor compliance with the price control arrangements.

It took us much longer than expected to complete the DPCR5 RIGs. In DPCR5 we introduced a range of new incentives, output measures and obligations on the DNOs and this entailed a significant increase in, and change to, the data we need to collect from the companies.

In future reviews we need to think about the reporting implications when we are developing policy recommendations to ensure that the proposals can be implemented and the reporting arrangements are proportionate to what we are trying to achieve. We also need to start developing the RIGs earlier so that we can conclude the process shortly after the commencement of the new review period. We will work this into our plans for TPCR5 and GDPCR2.

Improved engagement with the Committee of the Authority

The DNOs would have liked longer with the Committee of the Authority. We suspect time constraints will make it difficult to accommodate this request (either in GDPCR2/TPCR5 or at subsequent electricity distribution price control reviews). However, we hope that by opening discussion on WACC (and other financial matters) earlier, and closing down detailed discussions on benchmarking methodologies sooner, the network companies will feel they can make better use of the time they have with the Committee.

We are also looking to develop more effective engagement across all stakeholders for the up coming reviews which are consistent with the principles we set out in our RPI-X@20 proposals in January¹ on constructive engagement. We will be consulting at the end of the month on our public consultation process.

We would like to thank all those who contributed to the DPCR5 review as well as those who responding to the lessons learned exercise. If you have any questions in relation to this letter please contact Karron Baker by email karron.baker@ofgem.gov.uk or by phone on 0207 901 7350.

Yours faithfully,



Rachel Fletcher
Partner, Distribution

¹ ['Regulating energy networks for the future: RPI-X@20 Emerging Thinking' 20 January 2010](#) ref 5/10