

Rachel Fletcher
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30 March 2010

Dear Rachel,

Electricity Distribution Price Control - Review of process

Thank you for the opportunity to comment on Ofgem's DPCR5 process. I can confirm that this letter and attachment may be placed on Ofgem's website.

From our perspective there were a number of significant improvements compared to the previous reviews. The elements which we believe were particularly positive were the:

- Introduction of stakeholder engagement as a recognised input into the price control process;
- Increased transparency of Ofgem's decision making process in a number of areas; and
- Closer collaboration between Ofgem and the DNOs in the drafting of the licence conditions to support the new framework

Our biggest concern, by some margin, was Ofgem's use of Return on Regulated Equity (RoRE) analysis to calibrate the regulatory package and set the weight average cost of capital. The outcome of this was that averagely efficient DNOs must outperform the settlement to earn an average WACC for the sector. This was a significant change to the established regulatory framework – in which an averagely efficient company would be assumed to earn the WACC for the sector without incentive out-performance. This important change was not signalled transparently to the companies and nor was it delivered in a transparent manner. Such a lack of transparency, in one of the key elements of the price control framework, does not, in our view, satisfy the requirements of better regulation and Ofgem should strive not to repeat it.

We have set out our other comments in the attachment to this letter. If you have any questions regarding this response please do not hesitate to contact me.

Yours sincerely

Paul Delamare
DPCR5 Programme Director

Electricity Distribution Price Control – review of process – detailed comments

Our detailed comments on the themes raised in Ofgem’s areas for consideration are set out below.

Communications and stakeholder engagement

In general, we believe that the range of communication we had with Ofgem was good. In particular, Ofgem’s team generally made themselves available to discuss issues and respond to queries.

There were some occasions when it was clear that there could be better communications within Ofgem’s team. For example, at one point it was not clear whether non-operational capex was “owned” by the Costs Team or the Networks Investment Team. In saying this, we in no way wish to criticise the individuals concerned. We suspect this was a resource issue with busy teams struggling to find time to update colleagues.

We believe that the number of consultation papers, including the intermediate letters, was about right. These papers were generally very comprehensive, but sometimes it was difficult to track through the various tables to gain an understanding of the complete picture (we often had to wait for the financial model to do this). In some cases, the documents appeared to be put together in haste – again pointing to possible resourcing issues. It would also be helpful for Ofgem to develop a standard model for charts and tables in which the relevant price level is always shown.

We particularly valued the opportunities to present our views on the process and initial outcomes at both the bilateral meetings with Ofgem senior management and with the Authority DPCR Committee. With regard to the latter, at just one hour in duration, the Authority meetings gave little time to present complex price control issues. We believe that having more time, for example two hours, would give us time to explain the background to particular issues and as a result have a more in depth discussion and informed discussion.

We fully support Ofgem seeking views from all stakeholders and encourage Ofgem to have dialogue with all users of DNO services. In this regard we particularly support Ofgem’s (willingness to pay) survey of small customers, as well as its engagement with its Consumer Challenge Group and with Consumer Focus.

We continue to be concerned about the special treatment apparently given to Centrica throughout the review. We understand that Centrica put considerable effort into responding to consultation documents etc, however, Ofgem gave them preferential treatment by inviting them to have their own meetings with the Authority DPCR Committee – invitations which, as far as we are aware, were not made to other non-DNO stakeholders.

The continued use of DNO-Ofgem working groups to discuss detailed issues was another positive aspect of the review. However, we believe that the Ofgem senior management/DNO regulation managers' meeting was underutilised. We had envisaged this group discussing the main price control issues and overseeing the activities of the working groups. However, it met relatively infrequently and did not fulfil these objectives. We believe that this should be addressed for future price controls.

DPCR5 process and information requirements

We found Ofgem's publication of a high level timetable beneficial as it allowed us to plan our own resource requirements. We accept that undertaking a price control is a complex project and we understand why it had to adjust its project plan to deal with issues as they arise. Nevertheless, there were a number of policy issues which were not resolved until late on in the processes.

We believe that if a number of policy issues had been decided early in the process it would have reduced the burden on both the companies and Ofgem. For example, the decision to exclude sole use connections from the price control resulted in significant rework of the Forecast Business Plan Questionnaire. As a consequence, the DNOs were required to undertake significant reworking of their data in real time. Additionally, because Ofgem did not have sufficient time to fully think through their requirements this resulted in guidance which was unclear and hence interpreted differently by the DNOs. This in turn resulted in increased work for Ofgem as it tried to compare the data and ultimately for the DNOs as further resubmissions of data were required.

A further example of this problem was the development of the Load Index (LI) Output Measures through a series of revisions to the FBPQ tables and Supplementary Questions. There was a considerable amount of re-work involved in producing information to meet Ofgem's changing requirements and we are certain that progress to the LI would have been more efficient if there had been a clearly defined objective at an earlier stage in the process.

Another area where we believe improvements can be made is aligning the on going collection of data with the requirements of Ofgem's cost efficiency assessment processes. For some cost categories Ofgem required the DNOs to disaggregate the data to a lower level than was required for the annual regulatory reporting process. Whilst it is difficult to forecast all the data needed for a price control review in advance, it should be an important objective of the regulatory reporting processes to ensure that the data collected has a defined purpose within the framework.

Ofgem's RPI-X@20 project Emerging Thinking document paints a picture of an even more challenging environment in which there are bespoke services agreed with stakeholders as well as greater inter-changeability between opex and capex delivery solutions. We believe that this will pose additional challenges on Ofgem's price control period which could

result in even more detailed information being required in order to be able to use benchmarking tools in a robust way.

Ofgem has significantly increased the level of reporting required for DPCR5 in advance of concluding its RPI-X@20 project. Consideration should be given to reviewing DNO regulatory reporting in the light of the project's conclusions, including a reflection on the implementation issues arising as part of the forthcoming GDPR and the TPCR. One of the drivers behind the DPCR4 Regulatory Reporting pack was to reduce the burden on the companies during price control reviews. We believe that this objective was only partly met. In our view, improved reporting under the RRP exposed the lack of comparability between DNO submissions which in turn created the need for even more information to help normalise the data and to decide upon appropriate cost drivers. Although this will be inevitable to a degree, a more robust approach to ensuring adherence to the RRP rules would have reduced the scale of the challenge at the review.

We also believe the process of seeking clarifications on points raised throughout the DPCR5 process can be improved, especially where similar clarifications issues are raised by multiple parties. We note that commercial tendering processes usually require any unilateral query or request for clarification to be broadcast to all parties to the tender and we would recommend that Ofgem consider adopting an equivalent process in future price reviews. In other words, queries raised by individual parties and addressed by Ofgem (unless of a confidential nature) would be better shared with all parties rather than left as bilateral discussions. In this regard, we envisage Ofgem establishing an area on the all DNO section of its extranet site which would contain a register of clarifications provided.

Operating cost efficiency analysis

Ofgem's approach to cost efficiency assessment was superior to that undertaken for DPCR4, particularly in respect of operating and indirect costs. In particular, we welcomed the recognition that there are a range of factors (drivers) which have differential impacts on the operational costs of DNOs, and where these impacts can be quantitatively demonstrated they should be adjusted for in the benchmarking. In addition, the use of an academic advisor to assist in the development of both the overall approach and statistical models was a positive step forward which should be repeated for future reviews.

We also welcomed the greater sharing by Ofgem of the data underpinning its models and the outputs, including how it had derived the allowances. This allowed the DNOs to analyse the models and provide Ofgem with feedback on any errors. This improved the overall robustness of the benchmarking process. We also believe that the use of expert consultants to review certain aspects of the DNO cost base was positive. These processes ensured that the costs were compared against appropriate benchmarks for that activity. Additionally, it allowed DNOs to present their overall strategy in these areas so that the consultants were able to develop a more holistic view of a company's efficiency. We

believe there is merit in extending the use of expert consultant review to other aspects of the cost base e.g. Finance, Human Resources.

Our main area of concern was with the lack of transparency in Ofgem's use of regulatory judgement, when defining the final efficiency scores. We accept that it would be inappropriate for Ofgem to apply a mechanistic process to defining these scores and accept that regulators must use judgement to some degree. However, we believe if the process is to be transparent then Ofgem must set out the basis for why it has reached a particular judgement. This was not the case in relation to the weightings applied to the individual regression analyses. The choice of weighting has a material impact on the overall outcome and it is inappropriate for companies not to be provided with an explanation as to why Ofgem has come to a particular view. We ask that this is addressed in future reviews.

Operation of the IQI

We continue to support Ofgem's IQI incentive, but believe that improvements can be made to the way it is implemented.

Our principal concerns stems from the fact that the power of this incentive comes from the DNOs knowing what the "rules of the game" are prior to constructing their business plans. However, in DPCR5 there were number of key rule changes post business plan submission:

- The choice of matrix used
- Extension of the scope to include operating and some indirect costs
- Exclusion of HILP, CNI, Black Start and Discretionary investment.

Investment analysis

We welcome the good relationship with the Network Investment Team. We believe that all parties can be satisfied with the substantial progress that the working groups made on many issues, not least the development of Network Output Measures.

We also welcomed Ofgem's practical approach to the treatment of High Value Projects and the willingness to review the London investment plans in detail.

We had expected that the unit cost information which we produced to accompany the February submission would become part of a collaborative benchmarking exercise in order to develop a comparable unit cost dataset. Consequently, we were disappointed with the lack of transparency in Ofgem's approach to median costing, particularly in view of the resulting substantial reductions to our submissions. We note that the DNOs collectively have made important improvements in this area post the review through the Network

Asset and Data Performance Reporting (NADPR) Working Group which will pave the way for a more robust approach in future reviews.

In some areas, it would have been helpful to have time for more debate on specific issues. For example, Ofgem's decision to defer BT21CN investment appears to have been influenced by the strategy of one DNO, which we demonstrated in several submissions, was not our view. Also, our technical losses reduction submission was discounted without the further comparative analysis which we proposed on several occasions.

We note that the Output RIGs contain statements regarding the general immaturity of the outputs process and the commitment to continuous improvement. However, Ofgem's decision to take the optional power to impose a revenue adjustment based on a qualitative view of delivery of outputs is a cause for concern. This is because of the many and various inconsistencies in starting positions and approaches between the DNOs and the wide-ranging opportunities to analyse and draw comparisons.

Detailed implementation of the proposals

A key aspect of the DPCR5 framework is the substantial increase in the level of regulatory reporting. Whilst Ofgem has set out its rationale for needing this level of information and has committed to review, at a later stage, whether all of the data is required on an ongoing basis our chief concern is with the compressed implementation timescales. At the end of March we still do not have a complete set of tables with their associated guidance to enable us to fully understand what data we will have to record from the 1st April 2010. In our view this issue stems from the fact that Ofgem was under-resourced at the end of the process. As a consequence, the DPCR5 data requirements had to be developed after the licence conditions rather than developing them concurrently. We believe that Ofgem should look to increase its resource levels at the end of the price control process to ensure that sufficient time is allowed to properly develop the implementation requirements for any future control.

EDF Energy
30 March 2010