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Dear Rachel

### **Electricity Distribution Price Control Review (DPCR5) - Initial Consultation Document**

Thank you for the opportunity to comment on the recently published Initial Consultation Document. This letter summarises our key comments - the attached schedule also includes answers to the specific questions raised, as well as a further appendix focusing on a number of detailed customer-related issues.

There has never been more interest in the energy industry, and its impact on society, the economy and the environment. In setting the tone for DPCR5, this consultation is an opportunity to show direction and leadership by defining the significant contribution of power networks to future energy security and sustainability.

We very much recognise and support your three key objectives of environment, customers, and efficient networks. These aims are aligned with our own priorities as stated in our business strategy:

- **Safety** – the safety of our employees, service providers and the safety of the general public will always be our number one priority.
- **Network Performance and Customer Service** – putting the customer at the heart of everything we do.
- **Cost** – to be recognised as an efficient Network Operator.
- **Sustainability** – in terms of our resources and approach to asset management being responsible for our own carbon footprint and the facilitation of a future low carbon economy.

In considering these priorities, it is also important to note that, under RPI-X, Distribution charges have fallen by some 50% in real terms since privatisation in 1990 as Distribution Network Operators (DNOs) have reduced their costs and become more efficient. Indeed Central Networks' domestic customers now pay, on average, the lowest network charges of any DNO in the UK.



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The rest of this summary, and our response, follow Ofgem's headings in the consultation document: **environment, customers, networks, finance and process.**

### **Environment**

The UK's energy infrastructure faces significant challenges within the immediate future to deliver the Government's energy policy on supply security, affordability and environmental protection. DNOs are uniquely placed to drive this change but, in order to tackle these challenges effectively and efficiently, it is vital to have a regulatory framework that demonstrates leadership and reflects new costs and risks. Our main points are as follows:

- It is important to design an incentive framework which recognises the additional costs and risks borne by companies who take a leading role in innovation.
- The current innovation mechanisms are working well but need to be broadened in scope to allow DNOs to monitor and pilot the different technological and commercial models needed to respond quickly to changing customer and policy drivers.
- To remove barriers to the connection of Distributed Generation (DG), support of costs for increased dedicated specialist resource is required as well as a potential move to a shallow charging mechanism.
- We propose a quasi-output carbon mechanism that would incentivise DNOs to reduce their overall carbon impact.

As acknowledged by Ofgem, over previous periods RPI-X has reduced prices to customers but has caused DNOs to focus on their core operations, potentially constraining innovation and development. We are keen to work with Ofgem to extend the current innovation incentives to support technical and commercial pilot projects aimed at wider take-up of DG and demand-side measures, so that we are able to respond quickly and efficiently to accelerated growth in the future. Additionally, improvements to business as usual connections processes for DG will require increased dedicated specialist resource, and the review must identify an appropriate method to fund this.

The existing DG incentive mechanism promotes efficiency and helps to commute any reinforcement costs into an ongoing Generator Use of System (GUoS) charge. Nevertheless, the cost of investment necessary to rebalance the network and allow power to flow both ways remains a barrier to new DG projects. This would suggest that we potentially need a move to a shallow connection charge for DG and effectively move some of these costs to those that will benefit, i.e. the wider demand customer base. We note that, in effect, transmission connected generators gain free access to the distribution system and suggest that this may be justification for adjustment of the regime in respect of DG. Locational price signals, inclusive of any benefits, will be given via Use of System charges where appropriate. Associated uncertainty of volumes and connection location (i.e. costs) would lead to increased volatility of load related expenditure, which could be addressed through the development of a new revenue driver mechanism.

Central Networks has two of the lowest loss networks in the UK. Our network losses have reduced substantially over recent years and we are also addressing our non-network carbon footprint. The current losses mechanism has been effective in realising reductions in losses. However, future loss reductions will be increasingly hard won, and will require

fundamental changes to networks and their components. Given this background, and the desire to create a more direct link with environmental goals, we propose moving to a quasi-output incentive mechanism for network losses (and possibly overall carbon). Such a mechanism could match reward to outputs, but would recognise that not all outputs may be directly measurable, especially in the short-term. It would therefore be based, at least in part, upon the calculated carbon reduction of an innovation or investment. The mechanism would remunerate DNOs for efficient choices, based upon an agreed forward price of carbon and appropriate sharing of benefits with customers.

We fully support Ofgem's challenge to DNOs to play a more active role to facilitate a low carbon economy. We are therefore keen to work with Ofgem to develop a framework which promotes and funds a more proactive approach whilst also recognising some of the associated risks and uncertainties over the DPCR5 period and beyond.

### **Customers**

Satisfying the needs of our customers is central to our vision of an enduring role for networks, and is reflected in the research that we have undertaken to improve our service. We support enhancement of the incentive framework for connections, and believe there is value in new incentives for information provision. In response to this, we remain the only company to introduce on-line, real time fault and restoration information. On the whole, however, we are confident that the existing incentives and guaranteed standards serve customers well, and substantial change is neither necessary nor likely to deliver further significant benefits.

- The current incentive rates on interruptions and guarantees of standards fairly balance the risk and reward between DNOs and customers and continue to deliver benefits to customers. Tightening of the standards will not automatically drive further improvements but will increase costs.
- Basic commercial drivers mean that competition in connections is unlikely to flourish in all segments, particularly small scale (e.g. fewer than four domestic premises).
- Where competition is the most efficient way to protect customers, then further work is needed to improve measures in assessing competitiveness to include e.g. service levels, and address treatment of costs and margins to ensure DNOs are not unduly disadvantaged.
- Where competition is less effective, there is scope for enhancing the incentive regime, particularly in the areas of completion time and cost transparency, although complete standardisation of costs and processes across DNOs would be neither practical nor desirable.
- To be effective, future discretionary awards in areas where outputs are difficult to measure must reflect greater transparency and objectivity than that operated at present.

Any decision on moving to a 12 hour restoration standard should consider customers' willingness to pay and their potential disturbance against the costs DNOs would reasonably incur in providing any enhancement. The extra cost for a move to a 12 hour restoration standard will be largely driven by the increased costs of night working.

Equally, changes to the current Information Incentive Scheme (IIS) should only be made if sufficiently reflected in the targets set or if there was a tangible recognition in the cost of capital for DNOs bearing this additional risk. For example, tightening exceptional event thresholds to limit the number of claims would lead to increased volatility of CI and CML performance. This additional volatility would make it harder to identify improvement trends and would also increase the risk of DNOs incurring penalties due to circumstances outside their control.

We are aware of the criticisms directed at the industry in respect of new connections. We have been working hard to facilitate a competitive market by making customers more aware of their choices, providing greater transparency of our processes and policies around point of connection and adoption, and delivering improvements in terms of timescales to provide a point of connection both prior to and following the implementation of a new Licence Condition last year. We have also been developing new on-line processes to simplify and speed up the application process that will also allow customers to enquire about progress. As a result, we have seen increasing levels of customer satisfaction recorded in our own customer surveys and a fall in complaints.

The findings of our own customer survey work are that the evolving connections market is differentiated by service rather than price and that service levels underpin the development of competition in the market. The small end of the market (e.g. fewer than four domestic connections) has remained less appealing to new entrants. Any consideration of structural separation will need to take account of the potential detriment in service that would be experienced by those customers who would not be in a position to benefit from competition. Separation would create multiple hand-offs between the DNO and the connection provider, as well as increased costs from the loss of synergies between the DNOs' core networks activity and the associated connections activities which it is required to provide under statute.

For those customers who are unlikely to be touched by competition, we support the view that new or enhanced incentive measures for service or price may be appropriate, although these need to be designed in a way that takes proper account of cost drivers and constraints on delivery timescales. For the areas of the market that are becoming competitive, Ofgem should set out criteria for measuring competition that go beyond price and market share, for example customer awareness, customer service and innovation. Where these criteria are met, DNOs should be entitled to earn a margin, otherwise the emerging market will be distorted. To enable this to happen, DPCR5 will need to address the regulatory treatment of connections costs by separating the treatment of connections from the RAV so that a level playing field is created.

The definition and application of the cost apportionment factor which allocates costs between general and specific customers should be reviewed as we still believe it recovers an excessive proportion of the reinforcement costs from the overall customer base.

The discretionary award is a useful mechanism to reward leadership in those areas where specific outputs are hard to quantify, or may not be enduring. We have already shared our views with Ofgem on the need to improve the objectivity of the awards process and transparency of the success criteria. Subject to these changes, we would support a broadening of the scope of the award to cover leadership in other areas, for example the environment or safety.

In summary, therefore, Ofgem's agenda of ensuring the customer is at the heart of our business aligns very closely with our own strategic priorities. We have identified some areas for improvement, but overall the existing framework remains in a good shape to protect customers' interests.

### **Networks**

DNOs face a challenging task in efficiently delivering the necessary replacement of assets, facilitating the delivery of a low carbon economy and developing and maintaining a skill base to achieve these aims. At the same time, global demand for commodities and plant is increasing prices and delivery lead times. Against this background, our main points are as follows:

- Input costs are increasing and will continue to do so, and in order to deliver sustainable investment, DNOs need to increase their spend on developing the right capacity and skills in their workforce.
- We would support the removal of the volume related revenue driver and advocate its replacement by a mechanism for better managing funding and risk of customer-led costs.
- We do not support the view that there are strong incentives for DNOs to inflate and then underspend their capex allowances.
- We support the need to develop improved risk measures, although the industry needs to work together to address practical obstacles that prevent an incentive mechanism being implemented at this review.
- Although Ofgem has recognised issues with the DPCR4 benchmarking methodology, there is still more work to do in developing an approach that does not distort cost comparisons.
- We support Ofgem's building block approach but would argue strongly for the inclusion of all investment related costs e.g. project managers and designers, vehicles etc. within the network costs grouping.
- Continued part-funding of opex costs by shareholders (£63 million in 2006/07) cannot be considered sustainable given the need to maintain service levels in an environment of increasing cost pressures.

Whilst quality of supply (as measured by CIs and CMLs) shows an improving trend across the UK, asset modelling shows a growing need to replace the ageing asset base to manage future risk. Material and labour costs continue to increase, driven by domestic and international competition for limited capacity, and are likely to continue to do so over the DPCR5 period. The increasing numbers of infrastructure projects in the UK and worldwide will only exacerbate this trend. Associated with this is a growing need for investment in long-term development of an adequately sized and skilled workforce.

In setting cost allowances, the issues of increasing input prices and investment in skills must therefore be acknowledged, whilst also incorporating the significant uncertainties around DG and other customer-driven investment. We broadly support Ofgem's adoption of the building block approach to compiling cost forecasts, outlined in the consultation paper.

In respect of customer-led costs, we would support the removal of the current basic revenue driver but do not believe it appropriate for DNOs to take on the full risk of customer-driven investment. We therefore propose allowances are made flexible enough to fund DNOs for efficient costs incurred at customers' behest. This could mean a work volume revenue driver linked to costs (capex and opex) where they are relatively predictable (but volumes are not) or alternatively via some form of logging up mechanism.

In an enduring price control framework, we believe that companies do not have an incentive to overstate capital requirements. The current Information Quality Incentive (IQI) together with regulatory scrutiny, both at periodic reviews and within periods, provides sufficient checks and balances to remove this risk.

The consultation document raises the question of incentives for wider output measures, for example network risk. Central Networks and other companies have invested in the robustness of their Asset Management processes by gaining PAS 55 certification, and this is improving monitoring and measurement of risk. We support the aspiration of wider network risk measures, but have set out a number of issues that will need to be addressed during DPCR5 before any incentive structure can be created.

In terms of benchmarking efficient costs, we have already progressed our thinking from DPCR4 and have shared this with Ofgem. In order to create a sustainable platform for companies to efficiently invest to replace their networks, a number of distortions must be rectified. We therefore welcome the work that Ofgem is conducting to tackle the current biases in favour of outsourcing and remove potentially distortive cost allocations. However, whilst we support the overall building block approach, we do not believe that the split of business and network costs, as currently proposed, fully recognises drivers of engineering costs e.g. the project managers and designers, vehicles etc. required to deliver increasing levels of investment.

The need for a review of cost allocation and benchmarking is highlighted in Ofgem's 2006/07 cost report. Overall, the current framework incentivises the industry to control costs, which were roughly static in real terms. However, in 2006/07 the industry overspent its opex allowances by nine per cent (£63 million). Some factors behind this include increasing costs of vegetation management, activity related engineering indirect costs and inspection and maintenance to improve network performance. Continued shareholder funding of this magnitude is not sustainable in the longer term.

In summary, we believe that DPCR5 will be a critical time in defining the success of networks. The cost framework must be robust enough to deal with significant challenges

and we therefore look forward to working with you over the coming months to develop it further.

### **Finance**

In the interests of all stakeholders, the outcome of DPCR5 should be one of increasing investment in the UK's distribution networks. A key part of delivering this outcome will be to ensure that investors continue to have the confidence to fund these new levels of investment in an environment of increasing uncertainty. For this to happen, the following points will need to be recognised during the review:

- Current market conditions indicate a return to long-term historical levels for the cost of debt.
- Existing highly-leveraged structures are unlikely to be sustainable in the long-term and it would be inappropriate for Ofgem to mandate any particular financial structure.
- The current flat approach to price control revenue profiles will result in a step change in prices between reviews which should be reduced in future through more cost-reflective revenue profiling.
- The current pensions pass through regime should continue, given increasing uncertainty in scheme funding levels.

The Cost of Capital must consider the cost of debt, which has returned to more long-term historical levels, the increasing cost of issuance and increased uncertainty in the capital markets. Ofgem should avoid reacting to specific events, both in terms of recent acquisitions and changes in pension's legislation, which have driven an imbalance of supply and demand for infrastructure assets and debt, for fear of increasing regulatory risk, which is not in the longer term interests of customers.

Financing should be a matter for the company and hence Ofgem should be wary of utilising more specific instruments which may discriminate in favour of or against any one model. Rather, Ofgem should continue to promote a more generic approach which continues to allow reasonable access to funds, irrespective of their source. When DNOs are required to fund increasing and potentially more uncertain investment accessibility, predictability and stability will be key. In setting an efficient Cost of Capital allowance, Ofgem should ensure consistency across the various assumptions adopted and not look to adopt any specific measures which would either benefit or be detrimental to a particular ownership model.

We believe there are benefits to improved profiling of revenues. Mindful of the predicted increase in costs and investment, the historical approach to flat or reducing X with a greater focus on  $P_0$  will result in a stepped profile. It is therefore in all stakeholders' interests for Ofgem to have a longer term view on costs and prices and thus a more co-ordinated view of  $P_0$  and X within the final settlement. The current approach of  $X=0$  will lead to a more exaggerated increase in prices at DPCR5 than otherwise would be necessary under a more cost reflective revenue profile.

Lengthening predictions of life expectancy and increasingly stringent pension's legislation mean pensions costs will remain uncertain. Hence we support continuation of the current pass-through regime.

**Process**

Finally, in commenting on the proposed process and timetable, we would reflect on the successes of DPCR4, namely the use of industry workshops to tackle some of the more complex areas of the framework, the bi-lateral meetings between companies and the Authority at key stages in the process, and the publication of a 'September Update' document to facilitate consensus on a number of issues prior to the final proposals.

In summary, we support the focus of the consultation on the role of networks in the future and in particular our responsibilities in combating climate change and meeting our customers' increasing expectations. We therefore look forward to working with you to develop a framework which better facilitates this future environment.

I hope that you find our response valuable and if you have any questions please do not hesitate to contact me.

Yours sincerely

Jonathan Ashcroft  
Regulation and Commercial Manager

## 2 Environment

### Question 1

**Do you think that evolutionary or revolutionary changes are required to the role of the DNOs to ensure that distribution networks remain fit for purpose? If the latter, in what specific areas does this apply?**

- 2.1.1 The scale of the challenge in combating climate change is greater than any other threat facing the UK, Europe and wider world. The DNOs have a holistic view of the power delivery chain, are independent through their licence obligations and have an extensive skill base. They are in a unique position to play an important role in the delivery of lower carbon energy to homes and businesses.
- 2.1.2 Central Networks therefore believes that there is a requirement for both evolution and revolution in the role of the DNOs. Firstly there need to be revolutionary changes in how we actually think about the role of electricity networks and their contribution to a more sustainable future. This then provides the context for the cultural change, innovation and appropriately targeted investment that will direct the more evolutionary development of the actual infrastructure.

### Question 2

**Do you think that we have identified the key areas where DNOs can facilitate activities that have a positive impact on the environment?**

- 2.2.1 The Initial Consultation successfully outlines the key areas where DNOs can have a positive impact, from the development of the grid interface through to end customer efficiency initiatives.
- 2.2.2 During the DPCR5 period, increasing quantities of Distributed Energy, much of it from renewable sources, will mean that the traditional 'top-down' power flow model delivering energy from central generation sources is unlikely to be ubiquitous. We want to be active in facilitating the transition to a future where a significant proportion of power is generated, stored and managed locally, and are looking forward to engaging in the challenges.
- 2.2.3 The unique position of DNOs allows us to connect and integrate these new energy sources, applying appropriate solutions through a combination of reinforcement, technology and commercial agreements. Central Networks also believes that there is potential to play an active role in advising customers on specific energy efficiency measures that naturally complement engineering based network management solutions.
- 2.2.4 We recognise the opportunities of integrating energy storage and heat schemes alongside traditional generation. We also appreciate the role we can play in balancing supply with demand through demand side management, energy efficiency initiatives and active network management solutions.
- 2.2.5 However, these more innovative solutions place a considerable and non-routine demand on scarce resources. The RPI mechanism has been successful in driving down the overall cost base

of companies, but has tended to encourage DNOs to focus on core operations rather than innovation and technology development. As we will describe in our response to question 5, we therefore believe that the critical resource involved in distributed energy development should be grown outside the confines of the RPI-X mechanism.

- 2.2.6 DNOs can have a positive impact on the environment by continuing to facilitate the development of new technologies and innovative solutions. Continued investment in R&D, through the IFI scheme, will support the energy industry supply chain in delivering innovative solutions for the benefit of our customers.

### **Question 3**

#### **How do we ensure progress is made on the issues identified with the connection of DG? Should progress be facilitated through a working group or should more formal obligations be developed?**

- 2.3.1 We do believe that the development of more standardised distributed generation connection processes would be beneficial, and our engagement with generation stakeholders has provided an insight into their needs and aspirations. It does appear that the identification of some standard inputs and outputs across the UK would help customers, and ensure that our network designs maximise the potential for DE connection. We envisage a focus on common components, rather than end to end process, which would allow DNOs to organise their operations in a manner that reflects the regional characteristics of network and generation. We are therefore happy to work with other DNOs and stakeholders to agree common ground on this issue, and support the view that a working group or similar framework may be appropriate to develop the right picture and consensus across the UK.
- 2.3.2 We understand the demands to harmonise the connections framework and process across UK DNOs, and suggest that this could be done through a DNO group plus representation from generation developers. The requirements of ER G59 and G75 are designed to ensure the proper interface between distributed generators and the associated networks. The group will need to analyse the safety and network performance concerns and risks implied by the suggested relaxation, such that the potential outcomes are identified and fully accepted in advance by the relevant stakeholders.
- 2.3.3 There is a suggestion that DNOs could have been more engaged with the development of distributed generation. Although it may be concluded that the current DG revenue incentive appears not to drive DG activity significantly, our work with stakeholders indicates that planning consent difficulties are generally the biggest concern for developers. This could account for the relatively low levels of connection enquiries and subsequent delivery projects. We have actually been very active with our support of the UK's 'Distribution Working Group' and the introduction of the first Registered Power Zone. Whilst the DG Incentive should provide some encouragement to connect generation, the reality is that we are responsive to connection requests rather than reactive to the incentive which is itself not generally believed to be particularly strong relative to the connection costs.

#### Question 4

**Do you agree that DNOs should have stronger financial incentives to reduce their carbon footprint? Do you think that we have identified the key areas where it may be possible to do this?**

- 2.4.1 We agree in principle that stronger financial incentives would encourage DNOs to reduce their carbon footprint and the overall environmental impact of operating electricity networks. More specifically we agree that there is a need to develop a framework to direct activities that will specifically drive losses reductions. Whilst technical actions to reduce network losses can yield results, the ability to measure these is compromised by the relatively infrequent reading of most customer meters and by variations within the settlements system. A comprehensive roll-out of smart meters could, in the longer term, assist the assessment of losses in parts of the network, though the impact of unmetered supplies and illegal abstraction will still prevent absolute measurement.
- 2.4.2 We therefore suggest a quasi- output measurement that uses details of the additional investment incurred in the portfolio of projects that reduce losses. This additional investment would be compared against an NPV based assessment of the value of the carbon savings. The DNO would be incentivised by the availability of revenues derived from the beneficial investments occurring above the threshold, and likewise would not be encouraged to invest large sums where such benefits would not accrue. A universal model for such a scheme could be developed for the UK DNOs.
- 2.4.3 The scope of the incentive should be both the design of networks and their components, and energy consumption in operational buildings where savings could accrue from more effective energy management approaches. It also needs to be recognised that in some cases network losses may increase when distributed generation is added, which must be permitted without penalising the DNO.
- 2.4.4 In setting the hurdle for the price of carbon, it must be recognised that the opportunity to significantly change a particular network will typically not present itself over forty years or more, whilst the benefits will be delivered to society over this very long period. Therefore the carbon benefit assessment should similarly take due account of the future social cost of carbon, and not be limited by shorter term measures. We would also wish to ensure that networks continue to be planned and built for long term sustainability, not just to meet short term targets or reward mechanisms, and it is therefore possible that the strength of regulatory drivers for carbon reduction need to equal or exceed those of, for instance, quality of supply.
- 2.4.5 There is also an opportunity for DNOs to undertake energy saving initiatives such as network power factor correction, either within the distribution network, or at a customer's premises, possibly in conjunction with end user energy efficiency measures. Such actions could in some situations not only reduce losses, but possibly defer the need for network reinforcement.
- 2.4.6 We certainly understand the requirement to reduce our overall operational impact on the environment. Whilst the potency of SF6 is fully recognised by DNOs, the options for technology substitution for distribution networks are somewhat limited at present. Given that the volumes of SF6 used in most individual DNO plant items is very small, particularly at 11kV, we believe it

inappropriate to attempt to build an incentive arrangement where the companies have little opportunity to change behaviour. We certainly do support the continued emphasis on the treatment of any leaking equipment, the development of consistent recording, and also any initiatives to seek a more permanent solution, perhaps through the research and development route.

- 2.4.7 DNOs are already motivated to reduce cable fluid losses as part of their environmental management responsibilities, and especially where the routes coincide with Source Protection Zones for water collection. We have been working to better understand the condition and replacement demands of our fluid filled cable population as our repair activities indicate a growing need to introduce a level of systematic replacement. Whilst we support the development of leakage incentives, these should not supplant the requirement for important replacement activity required to ensure the ongoing health of the network and prevent delivery and security constraints as more general failures develop.
- 2.4.8 We support the extension of the 'Areas of Outstanding Natural Beauty' scheme. However, we feel that allowances should be increased to reflect the true cost of undergrounding. We would welcome the opportunity of working closer with AONB stakeholders to allow them a greater influence in decisions (for example in the trade-off between cost and location). More detailed comments may be found in Section 4.3 of the Appendix.
- 2.4.9 We are committed to reducing the environmental impact of our business in all areas. For example we are reviewing our vehicle fleet and the location of operational bases aimed at reducing the miles travelled and improving fleet environmental performance (e.g. mpg, CO<sub>2</sub> emissions). In our non-operational offices and depots we are aiming to reduce energy usage through energy efficiency and deploying renewable energy sources. We continue to deploy IT solutions to support the business and reduce travel, for example video conferencing and support for home working.
- 2.4.10 We will support Ofgem's workshop with the DNOs and other network operators and will gladly share the work currently being undertaken by Central Networks to understand our own carbon footprint. The workshop would also be useful to build a consensus on the treatment of fossil-fuelled mobile generation and similar carbon intensive activities directly associated with the operation of the networks.

## **Question 5**

### **How can the Long Term Development Statements be made more useful for DG and other users of the network?**

- 2.5.1 The Long Term Development Statement (LTDS) has been a useful focal point for the provision of technical network data to distributed generation developers. However, the format and type of data does mean that its application is currently quite limited. The anticipated increase in distributed generation development will engage many potential connectees, from both the larger and experienced generation companies to individuals assessing the viability and technical requirements for small domestic, agricultural or commercial units. We plan to develop forward looking costs for different parts of the EHV network as part of our structure of charges

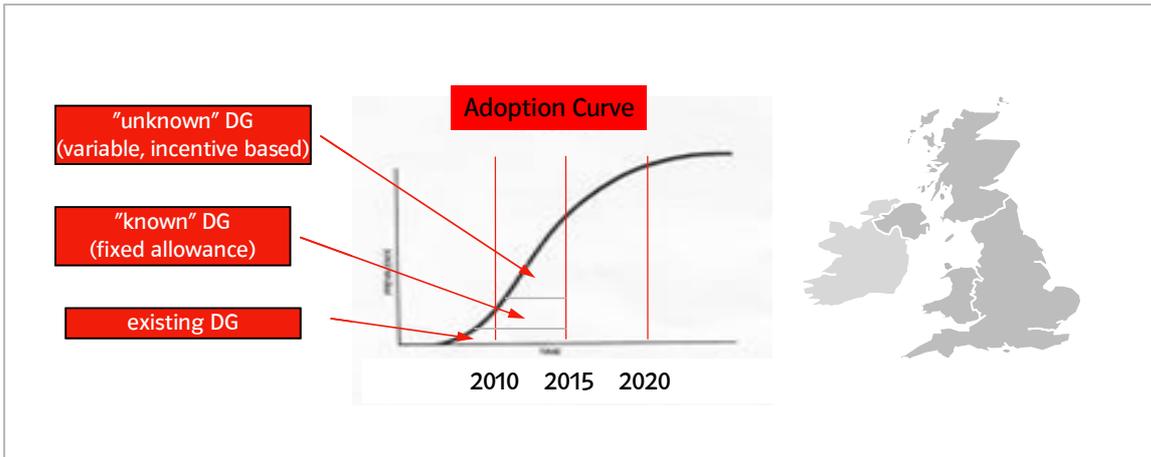
project and to publish this information via the LTDS to provide geographic investment guidance.

- 2.5.2 During our ongoing stakeholder engagement, generation companies have also made the general suggestion that the format of the LTDS could be aligned across the DNOs, and accessibility improved. We understand and support these aspirations.
- 2.5.3 We have already given our LTDS data to a company that has developed a user friendly internet based connection assessment tool using BERR sponsorship. We are also considering developing our own web based assessment tool for smaller generator connections.
- 2.5.4 We are keen to expand this interaction and improve the service provided to our customers, so that LTDS information and support is provided in a meaningful and user friendly way to customers and developers of all sizes. As with our response to Question 2, we propose an arrangement where resources employed in proactively publishing generation connection capabilities, and helping the many customers that may have generic, or site specific questions are isolated from the general pressure applied by the RPI-X mechanism.

## **Question 6**

### **Is the current regulatory framework constraining a DNO's ability to facilitate low/zero carbon technologies and, if so, what could be done to address this?**

- 2.6.1 The RPI-X formula has benefited customers, with prices down by 50% in real terms, since its introduction. However the mechanism has driven DNOs to focus on core operations and operational efficiency rather than funding proactive involvement or speculative opportunities. A new mechanism is now required that encourages growth of distributed generation and facilitates low and zero carbon technologies. We believe that the introduction of insightful regulation will not only supports this particular activity but also provide essential leadership and direction at an important time in the development of future energy security.
- 2.6.2 Inevitably the network long lead times in developing Distributed Energy schemes lead to uncertainty in the timing of investment. We therefore propose that part of our allowance should be fixed for the foreseeable generation projects within our regions. A 'top-down' modelling exercise based on the EU targets for renewable generation shows a significant 'gap' between the currently un-specified schemes required to meet the targets and those already identified by us. In order to protect both Central Networks and our customers, we believe funding for the unknown portion of projects should be on a variable, incentive based mechanism, (as illustrated in the figure below).



- 2.6.3 During the DPCR5 period and beyond, DNOs will become more centrally positioned in the management of generation capacity and the two way power flow between distribution and transmission. Our independence and unique position allows us to act as an aggregator for electrical energy, ultimately potentially being commercially incentivised to manage the important power interface between the national grid, distributed energy suppliers and demand customers along with the complex and real time optimisation of the distribution network. Clearly this approach would require quite significant changes to the current regulatory and commercial models.
- 2.6.4 Central Networks was an early participant in the RPZ scheme, with its innovative approach to the connection of wind generators in the east of the region. This particular application, along with the other RPZs, exploits the intermittency of generation output, and therefore allows generation to be connected at a lower cost than would otherwise be the case. Should the RPZ functionality be unavailable for whatever reason, the outcome would be a curtailment of generation rather than a loss of customer supply. There is however a question around the acceptability of these less secure arrangements for demand customers. We therefore conclude that we do see scope for the extension of the RPZ definition, and suggest this could usefully incorporate all initiatives that relate to the management of sustainability for networks and the network related carbon footprint.
- 2.6.5 Central Networks is committed to the development of DG and is keen to ensure that its contribution to network security and development is fully recognised. Generators have told us that the existing methodologies for determining connection costs and ongoing operating charges, in some cases, can prevent a scheme which has attained planning consent from proceeding. We therefore support the review of the 'structure of charges' and will implement charges that reflect the network reinforcement deferral potential and network benefits provided by DG. We support a move to 'shallow' rather than 'shallowish' connection charges for DG in order to ensure that developments are not curtailed by the cost of connections. Such charges could incorporate locational signals, inclusive of any benefits, given via Use of System charges covering future network operation and maintenance costs only. We believe this is not subsidy or discriminatory, merely levelling the playing field of a network constructed initially to facilitate centralised generation.

- 2.6.6 As our networks become more dynamic, and to ensure equality between generating locations, we suggest that generators that connected before April 2005 should in the longer term be similarly treated to those using the current arrangement.
- 2.6.7 Finally, we agree that it may not be seen as appropriate for our revenues to be adjusted by the current unit (kWh) driver. Consideration however should be given to determining an alternative more robust revenue driver to ensure the price control continues to reflect incremental costs, including reinforcement and customer driven investment, and gives DNOs an incentive to utilise the assets to maximum potential.

### **Question 7**

**We have raised more detailed questions throughout the chapter. We welcome views on these issues.**

- 2.7.1 All issues are discussed under Q1 – Q6.

## **3 Customers**

This section answers the first five questions in the customers section of the initial consultation document. There is also an additional appendix concerning customer related issues which goes into further detail to answer the questions in the initial consultation document and the supplementary appendix that accompanied it.

### **Question 1**

**Do the current regulatory arrangements deliver the levels of service that customers expect?**

- 3.1.1 We believe that generally the regulatory arrangements do deliver the levels of service that customers expect. The recent customer survey confirms customers' key interests continue to be:

- interruptions to supply,
- communications with their DNO, especially during supply interruptions, and
- a swift connections process providing value for money.

These areas are covered by incentives to improve or maintain our current levels of performance. The telephony survey consistently shows high levels of customer satisfaction, network performance shows an improving trend and guaranteed standard failures relating to connection estimates are low suggesting the incentives are effective. There are, however, some specific areas where we believe improvements can be made as discussed below.

#### **Interruptions to supply and worst served customer**

- 3.1.2 The IIS framework has led to progressive improvements in general network performance, but there are groups of customers, generally at the end of sparsely populated circuits, suffering poor performance where the cost of improvement work is disproportionate to the benefits that would be delivered. Since companies seek to invest to provide benefits to the maximum number of customers, then individual worst served customers may see limited improvements. We welcome the focus being given to these worst served customers, but do not believe that enhancing the guaranteed standards arrangements will provide sufficient targeting and focus

to make a difference (as detailed in the appendix). We are keen to work with the industry and Ofgem to determine a clear definition of worst served customers, collate the data to identify the groups of customers and areas of the network requiring attention and then develop specific solutions to improve performance. As this is a new area of focus, it requires a new funding mechanism, such as a targeted capex allowance. It is suggested that allowances could be set at a level to target worst served customers on a percentage basis (say 5% of the worst served getting an improved performance). Our proposals in relation to worst served customers are included in greater detail in section 1.4 of the appendix.

### **Telephony and Customer service issues**

- 3.1.3 While customers are generally happy with the telephony performance, we believe there is scope for DNOs to provide more pro-active communication during interruptions, for example using SMS text messages, web-sites etc. We look forward to the results of the ongoing customer survey work in relation to this issue.
- 3.1.4 In some cases customer expectations will always be difficult to satisfy and this is increasingly true for the payments relating to the guaranteed standards for loss of supply. Some customers will always expect higher payments than the guaranteed standards will provide them as they consider this payment to represent compensation. However it is a long standing principle that DNOs should not be expected to compensate for inconvenience and consequential loss from interruptions. Given the shared nature of electricity networks, which can create cross-subsidy issues, it is most economic for business to understand its risks and provide appropriate mitigation. Creating a compensation culture would divert increasing amounts of money into something which would be more like an insurance scheme in operation. This money would be better used to improve the reliability of networks. Further details of how we believe guaranteed standards should be developed are given in section 2.3 of the appendix.
- 3.1.5 Regrettably there will be circumstances where customers' reasonable expectations are not met. For DPCR5 we believe that the introduction of the redress schemes and the complaint handling standard will ensure that customer complaint handling and redress needs are met. These include comprehensive requirements such that introducing a further guaranteed standard would create unnecessary duplication and complication. This may even lead to the unintended effect of incentivising DNOs to provide speedy resolution by agreeing financial compensation rather than a more considered analysis to determine and correct process failures. Other potential problems with a guaranteed standard for complaints handling would be the overlap where other guaranteed standard payments have already been made and determining the point at which an issue is considered resolved. For example, there may be very different timescales involved in agreeing a corrective action plan with the customer and its final completion.

### **New Connections**

- 3.1.6 Customers require a cost effective, swift connections process, with effective communications with their connections provider. We believe that for contestable work the competition in the market offers customers choices in terms of delivery timescales, costs and levels of customer service and therefore:
1. these costs should be removed from the price control and costs/income for connections should therefore not impact the RAV, and

2. these customers do not require additional protection in the form of guaranteed standards, licence conditions, schedules of costs etc.

3.1.7 However where competition has little impact, such as one-off connections, then it is appropriate to protect customer interests with mechanisms such as guaranteed standards.

3.1.8 We agree with Ofgem that one of the issues of most interest to customers is the timescales taken to carry out new connections work. This issue was identified by our own customer surveys as being of importance to them. Consideration should be given to extending the guarantee for connection completion times to these customers. This should be aligned to the connection categories and descriptions of the existing estimate of charges guarantee. Any completion time guarantee would need to take account of events outside our control, for example, time delays due to the customer not being ready on site.

3.1.9 Care needs to be taken in determining the appropriate timescales for work not impacted by competition. Competitive connections providers are unlikely to compete for jobs that are considered awkward or financially unattractive. Over time as competitive connections increase this will result in the DNOs being left with a mix of work which has a higher proportion of challenging jobs. This needs to be reflected when setting standards.

3.1.10 In response to feedback already provided by our customers, we are implementing a number of initiatives to improve timescales for producing quotes and final connection via:

- online applications for metered and unmetered connections,
- standard pricing for some categories of connections, allowing refocus of resource on bespoke quotes where there is benefit to the customer,
- refocusing of internal and externally contracted workforce, and
- developing our work tracking systems and an electronic work scheduling tool.

## **Question 2**

**Is the focus and scope of the current regulatory arrangements correct and are there any gaps that need to be addressed?**

### **3.2.1 IIS Framework**

We consider that the focus and scope of the IIS is generally appropriate as the targets and symmetrical bands of reward/penalty act as a strong driver to improve general levels of network performance. However, as ongoing improvement work is made, then this will be reflected in the target setting process which will generate tighter limits. Eventually further improvement opportunities become limited, increasing the risk of failing to meet these tougher targets.

3.2.2 The IIS target setting process is complex, but the joint work between Ofgem and DNOs has developed a framework that seeks to drive performance towards challenging but reasonable benchmarks. We have proposals for some minor refinements of the benchmarking process to allow for the difficulty in reducing underground fault rates from inherent levels and to ensure that pre-arranged allowances recognise new drivers such as tree clearance under ESQCR. These are considered in more detail in section 1.1 of the appendix.

- 3.2.3 We firmly believe that the exceptional event exclusion mechanism should be set at the appropriate levels to determine a reasonable assessment of underlying performance by excluding the influence of significant weather events. We recognise Ofgem's concerns about the volume of claims, but do not agree that an average of two claims per DNO per annum is excessive. Tightening thresholds to limit the number of claims would lead to higher annual volatility. This additional volatility would make it harder to identify improvement trends and also increases the risk of DNOs incurring penalties due to circumstances outside their control. DNOs would therefore require either changes to the target setting methodology or additional compensation for bearing this additional risk. Our views concerning exceptional events are given in more detail in section 1.3 of the appendix.
- 3.2.4 Customers have benefited from cost effective investments in protection stages, remote control and automation that reduce the duration of interruptions. These improvements do not stop the faults from occurring, but mitigate the consequences of faults. Reducing the number of faults would require significantly greater investment to replace asset volumes at a greater rate than general network deterioration, which would be less cost effective at delivering improvements to customers. Therefore we do not believe the lack of a short interruptions incentive is skewing DNOs towards automation solutions at the expense of solutions which reduce the total number of faults.
- 3.2.5 There are still more opportunities where investment in automation would be cost-effective. Therefore, in the medium term this investment will continue and short interruptions will rise. However, it should be remembered that short interruptions represent success at avoiding long duration interruptions. Incentivising short interruptions could unintentionally reduce the benefits case for general improvements, reducing the number of automation schemes being implemented. At the same time, introducing a short interruptions incentive is unlikely to improve the cost effectiveness of fault reduction investment to a level that would trigger additional investment. For these reasons, we believe that short interruptions should not be considered for inclusion within the IIS.
- 3.2.6 **Guaranteed standards**  
Guaranteed standards provide a lower order incentive, driving further work to make improvements where customers experience poorer service. The guaranteed standards therefore theoretically add balance to the incentive framework as they focus on specific performance issues whereas the IIS incentives look at performance in more general terms. Getting the right balance between incentives, what customers want and what they are willing to pay for, is complicated and we do not believe that guaranteed standards are always the best mechanism to improve specific performance issues. The existing multiple interruption standard has not led to any significant improvements in service to worst served customers and therefore introducing further standards such as the suggested cumulative duration standard is unlikely to drive improvements. Similarly, reducing the 18 hour limit for restoration to 12 hours will impose additional costs on DNOs, but DNOs' actions to mitigate these payments may involve expense which is not cost effective, for example, assigning multiple teams to a fault. Ofgem must also acknowledge the increased disruption and noise to customers and risk to staff involved in repairing faults in the dark overnight. Again, if implemented, DNOs would require additional financing to allow them to meet such targets. Some suggestions as to how we believe guaranteed standards should be developed are given in section 2.3 of the appendix.

### 3.2.7 **Customer Service Incentives**

We believe there may be some gaps in the customer service incentives and that there is scope to include additional categories in the discretionary reward, such as the performance of DNOs during exceptional events. However, to be an effective incentive the discretionary award requires some changes. Our suggested improvements are detailed in section 2.2 of the appendix. Given the increased emphasis by customers on the environment then it seems sensible to give more emphasis to environmental incentives which could be achieved by separating the environmental aspect from the discretionary reward into its own category.

### 3.2.8 **Connections**

In areas exposed to competition customer services will be kept in check by market forces. For areas where competition is less likely to have an effect, there is some argument for additional incentives for DNOs. Some elements of this work, for example one-off domestic connections in urban areas, are often similar to each other in terms of costs and timescales and so may be suitable for standards relating to cost and completion time. Timescales for connections have already been discussed in our response to question 1.

3.2.9 In terms of cost, even relatively standard jobs are subject to regional variations and changes in material prices over time. Consequently, it may be better for the DNOs to have standard pricing mechanisms or methodologies than to cap charges directly. Other items, such as more complex work or connections to the overhead network, will show more cost variability. In these cases bespoke design and estimates are more appropriate than the use of standardised methodologies to avoid creating issues of cross subsidy between customers with differing requirements.

3.2.10 Currently the new connections enquiries under Section 16 are handled efficiently as a bundled service (contestable and non-contestable) and are designed and delivered by Energy Services acting as agent for and on behalf of Central Networks. This activity is structurally separated from the non-contestable service provided within Central Networks. Further separation extending to the bundled service would require additional interfaces in dealing with the contestable and non-contestable elements separately. These additional handoffs would create additional cost and delay in the process to the detriment of customers with connection requests that are unlikely to see competition.

3.2.11 There is also a need for greater clarity and consistency around Cost Apportionment to remove the current confusion of customers and competition. Therefore we see reviewing the Cost Apportionment rules as a priority.

## **Question 3**

### **Are DNOs customer focused enough or should they be doing more to improve communication with customers?**

3.3.1 We seek to provide high levels of customer service. The results of the telephone survey when compared across similar surveys in other industries suggest that DNOs generally perform well. However, there is still scope to improve further through:

- better information about restoration times,

- provision of information about future network investment,
- innovative ideas when dealing with customers in the field (e.g. customer support vehicles), and
- increasing the channels used to provide information to customers, for example SMS messaging to those customers who prefer this, and our website's live network map providing information on outages.

3.3.2 We welcome the trial of a new question in the telephony customer satisfaction survey asking customers how satisfied they were with the DNOs' communication during an outage. We believe this will encourage DNOs to be proactive in their communications.

3.3.3 We also expect the stakeholder engagement process for DPCR5 to reinforce an ongoing process rather than being a one-off exercise. For example, following our stakeholder engagement we are considering instigating a consumer panel to represent the needs of customers in our area.

3.3.4 To support our vision to be the leading connections provider, our related party providing connections, Energy Services, is currently undergoing restructuring. This is part of a change programme which intends to more effectively put the customer at the centre of what we do. As part of this we are increasing levels of information and communication for customers through the following initiatives:

- our website will allow online applications, payments and job tracking. This will also be an information resource for the customer with information, guidance notes and a product selection filter,
- we are setting up a technical helpline for customers, and
- proactive communication with customers at all stages of a project will be enabled by an end-to-end work management system and scheduling tool.

3.3.5 We will continue to use feedback from customer visits and monthly surveys to guide our change programme. We are also working on an internal standard for complaints handling which will communicate the process clearly to the customer.

#### **Question 4**

##### **Is DNOs' financial exposure set at the right level and/or do we need to change the emphasis in certain areas?**

###### **3.4.1 Interruptions to supply**

The opportunity to outperform targets and gain rewards provides an effective incentive to improve performance. The maximum 3% of revenue exposed provides an appropriate balance between incentive and risk for a DNO. Any significant increase to the DNOs' exposed revenue along with tightening of targets and potential limitation of exceptional event exclusions will increase the risk on DNOs.

3.4.2 The introduction of an enduring or rolling incentive would be a useful change to counter diminishing IIS scheme payback over the period. This would correct the current mechanism to recognise benefits to customers of investment irrespective of this reduced payback.

3.4.3 In principle we support changing incentives to better represent the customers' willingness to pay. However, given the uncertainty around target setting and exceptional events we are not yet able to support equalisation of incentive rates, as we cannot determine the resultant risk and opportunity.

3.4.4 **Customer service issues**

The IIS scheme has shown some success at providing a framework to encourage ongoing improvements. However the risk versus reward balance for other customer service incentives needs adjusting if it is to provide a stable way to finance consistently improving customer service activities. This is especially true for the discretionary reward.

3.4.5 Improvements to the judging mechanism are necessary if this award is to motivate DNOs. If left in its current form it is likely that some DNOs will fail to enter. The value of the discretionary reward to DNOs is not just financial, but motivational and therefore splitting it into more areas may help this reward to have the desired effect as more clearly defined areas will allow for better judging and also allow for better recognition of each DNO's strengths.

3.4.6 It is important that incentives do not reflect investment that may not be cost effective, for example by incentivising an aspect that is technology specific such as call answering speeds which are determined by the type of telephony system employed. This may encourage investment that may not be cost effective in terms of improving service to the customer.

## **Question 5**

### **Do you think we have identified the right issues and appropriate areas for development with the existing incentives?**

3.5.1 **Interruptions to supply**

In general the quality of supply incentives are working well and therefore some refinements are welcome but wholesale changes are unnecessary.

3.5.2 We are pleased that worst served customers are being considered and include more detailed views in section 1.4 of the appendix.

3.5.3 While we agree that improvements need to be made to the calculation of pre-arranged allowances, we do not believe that an excess of pre-arranged allowances is being used to offset fault restoration performance, indeed this could not apply to half the DNOs as their allowances were insufficient. Our suggested approach to setting pre-arranged allowances is contained within section 1.1.7 of the appendix.

3.5.4 We believe that short interruptions do not require incentivising as explained in our response to question 2.

## Question 6

**We have raised some detailed questions throughout this chapter. We welcome views on these issues.**

3.6.1 The detailed questions raised throughout the chapter have been answered in the customer service appendix.

## 4 Networks

### Question 1

**Have we captured all the key lessons learnt from DPCR4 regarding cost assessment?**

4.1.1 We agree that many of the issues we have previously highlighted as learning points have been signposted in the document. Our answers to the questions below reflect our view that we do not yet believe we can say all of the issues have been addressed, until we have dealt with further details. At a high level, the particular problems we believe are still outstanding are:

- The need to avoid distortions driven by cost allocation boundaries has been acknowledged with the use of network and business cost groups. However, the currently proposed definition of business costs still appears to include costs that are network driven – e.g. EMCS, design, project management, vehicles etc. We are also conscious that increased capital investment will also have a bearing on other costs, for example Control Room operations and Asset Information requirements. This must be addressed so that benchmarking of cost groups is carried out on a fair basis using appropriate cost drivers (see 4.4.3).
- The RRP data that has been shared between DNOs and Ofgem has been useful in improving the scope for more detailed and cost reflective benchmarking. However, the number of comparators means that a margin for error will still be present in any statistical comparison, even with the proposed use of panel data, and this will need to be addressed within the cost comparison process.
- We support the use of the IQI (sliding scale) incentive in principle, but need to work with Ofgem on interaction with the submission process, application to building blocks and design and calibration of the mechanism before we can provide a detailed reaction on its incentive properties. At DPCR4, the final decision on design and calibration of the incentive came at too late a stage for us to take full account of it in our planning process.

### Question 2

**Is our approach to cost assessment appropriate?**

4.2.1 Ofgem's proposals appear to have evolved positively from DPCR4. In developing the detail of the cost assessments our priorities are as follows:

- Cost estimates that are realistic, achievable and 'sustainable' (4.26) over the longer term must recognise the long term nature of investment and that costs may be incurred which lead delivery but improve long term efficiency (e.g. investment in skills). Ofgem should therefore avoid creating 'virtual' companies by assembling allowances based on the best

performance in each cost category and, rather, reflect activity levels in cost assessments and provide an allowance for sustainable skills and training. We are already investing now to deliver capability for DPCR5 and beyond<sup>1</sup>.

- The use of building blocks aligns the review more closely with DNOs' own planning processes. However, Ofgem's proposals to date do not appear to fully address distortion issues relating to comparability of indirect costs driven by differing levels of investment across DNOs (e.g. designers, project managers, vehicles etc.). We believe that there are costs currently assigned to the business costs that should be transferred to network costs. However, given that we do not yet know how these different costs will be capitalised, it is difficult to comment in detail.
- A transparent process for generating cost benchmarks so that any assumptions can be validated by stakeholders. In particular, the assumptions made in benchmarking of capex activities need to be sufficiently transparent to allow for reasonable scrutiny by DNOs.
- An assessment of frontier shift that explicitly accounts for both input cost rises and productivity improvements, related to appropriate sector benchmarks. Ofgem is right to acknowledge upward cost pressures, which are likely to become increasingly significant.
- Developing appropriate mechanisms to manage uncertainty in capex requirements. These could be revenue drivers (certain costs, uncertain volume) or the ability to log up costs (uncertain volume and costs, low materiality). In some cases, (e.g. where external resource needs to be secured) certainty of funding may help improve efficiency. In these cases, we could envisage a fixed allowance plus a variable driver to provide incentives for efficient management of risk. On removal of the growth term, we note that connection and general load related costs are ultimately driven by customers and hence DNOs cannot predict these with certainty.
- A balanced and holistic view of factors affecting costs. For example, differing business models, safety concerns, increasing frequency of 'extraordinary' wayleave easements or diversion capex or 'traditional' local factors, e.g. demand growth from local areas of development.
- Understanding the plans, processes, data and timescales required to develop a view on the best approach to incentivising outputs as a measure of the impact of investment delivered. The different DNOs all have varying asset management processes and the focus of activity during the DPCR5 period should be on determining the best way forward.

### Question 3

#### **Are there alternative approaches to cost assessment that we should be considering?**

4.3.1 The suitability of an upper quartile rather than average performance to determine efficiency levels needs to be reviewed given a growing consensus that further reductions in cost are not sustainable and inconsistent with continuing to deliver service to customers. Additionally, the

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<sup>1</sup> For example, orders have already been placed for major plant with long lead times for DPCR5 (32mths for 132kV transformer). We are also developing innovative ways to increase the resource base, such as working with other areas of E.ON, developing strategic alliances with our suppliers and working with the Power Academy and Power Networks Research Academy

building blocks approach will be based on key assumptions and views on perceived roles of the DNOs, making direct comparison less meaningful.

- 4.3.2 We would welcome the consideration of a body of evidence, rather than reliance on one specific benchmarking methodology. Ofgem adopted this approach at DPCR4, and we would encourage a similar approach at DPCR5. The next few months should be used to determine which methods will be considered and how the results will be assessed. We would like to see a consideration of total cost methodologies included in the consideration of different techniques (4.65).
- 4.3.3 We would expect that significant changes to the framework would be picked up at the 'RPI at 20' review, which we welcome. Ideas for consideration in the RPI at 20 review could include:
- further tailoring of the regulatory contract to match the DNOs' business plans and stakeholders' expectations. One way to do this would be to offer different packages or options for performance incentives with tailored triggers or risk/reward balances,
  - incentives for companies to co-operate to reduce costs of managing uncertainties and constraints (e.g. skills or developing a regulatory and commercial framework to support active networks).

#### **Question 4**

##### **How might our approach to benchmarking be improved?**

- 4.4.1 We have already discussed with Ofgem how the treatment of indirect costs within the current framework provides an incentive to outsource capital work rather than to find the best value. We believe that the use of Totex benchmarking for a single year may solve this. An alternative option would be to define a network costs block containing internal indirect costs that would be aligned with direct costs, equivalent to an outsourced approach.
- 4.4.2 We strongly support the use of a cost driver reflecting investment and capital work volumes – for example the capex metric we have already discussed with Ofgem. It will be appropriate to capitalise costs that support capital work (e.g. vehicle and transport costs, project management, EMCS etc.) DPCR5 capitalisation policy needs to reflect the acknowledgement made in TPCR4 that where opex has significant life extension effects it should be eligible for treatment as quasi-capex.
- 4.4.3 Ofgem should not group costs together that have different drivers as this will make the results less reliable. For example, some costs are affected by just scale, others by a mix of scale and capex activity, and other costs may have their own unique drivers. Costs should only be grouped (i.e. added together) where drivers are consistent. We note that multivariate regression may fail to identify the correct drivers for costs within a group that is relatively small. At present, Ofgem have not specified how costs will be grouped together for benchmarking. However, load related capex, non load related capex, faults, trees and I&M are dissimilar enough to make us concerned if all the costs are grouped together and assessed using a single scale driver. We will repeat our driver analysis, which we have already discussed with Ofgem, using 2007-08 data and this will help us to make final recommendations for cost groupings.
- 4.4.4 We are encouraged by Ofgem's comprehensive plan of work regarding benchmarking and share the eagerness to address these issues as soon as possible. Of the proposed adjustments we

consider that priority needs to be given to those for regional cost adjustments and the degree of outsourcing. We believe that, in constructing a regional cost adjustment, the cost comparisons made must relate to our own industry to be valid. In terms of outsourcing we think the current approach may be improved using our understanding of cost drivers. For example, costs for vehicles and transport costs are closely related to direct staff, so understanding the change in staff required to achieve an average level of outsourcing would give an indication of the appropriate adjustment for vehicle and transport costs.

- 4.4.5 Finally, Ofgem's approach to reconciliation of top down and bottom up methodologies needs to be developed with the industry early on in the process, so that the allowances can stand up to cross-checking and not simply be based on the lowest possible combination, thereby creating a virtual company.

## **Question 5**

### **Have we captured all the key issues for networks?**

- 4.5.1 The review should consider business costs associated with the challenge of a shift in role to a more active network manager that we have referred to in section 2 of our response, for example:
- developing a contractual framework to handle the use of distributed generation (DG) to defer reinforcement, and
  - cost increases driven by the need for a wider technical skill set, time required to create innovative solutions that reduce costs for customers and enhancements to the IT&T systems.
- 4.5.2 Whilst delivery challenges have resulted in an apparent underspend against allowance in the DPCR4 period to date, delivery phasing must be taken into account and Central Networks expects to spend the agreed allowance during DPCR4. We are addressing these delivery challenges through investment in training and recruitment, and the development of new approaches to delivery. However, it is important that these challenges, which will continue into DPCR5, are recognised and addressed during the review. CN West was one of the two DNOs that fully spent its capex allowance in 2006/07 (figure 4.2).
- 4.5.3 During the review process, Government is likely to decide on its preferred roll-out method for smart meters. From the information we have seen about the modelling process and some views from suppliers, it is clear there is a belief that benefits could accrue to DNOs. We dispute the level of short term financial benefits being suggested for DNOs. Material and enduring benefits are dependent on technology choice and infrastructure and will lag a comprehensive roll-out programme, which itself will entail up-front investment in changes to data communication systems.

## **Question 6**

### **Is our building block approach to forecasting appropriate?**

- 4.6.1 We believe the proposed building block approach will allow greater transparency for both Ofgem and the DNOs over exactly what has been agreed. Therefore, subject to the comments about detailed cost treatment raised above, we support the fundamental approach, particularly

as it is closely aligned with our own plan development.

- 4.6.2 Different DNOs' networks have different inherent structures and risks, and maintaining their current status may not be the optimal way of funding network development into the future. The building block approach gives each DNO the opportunity to identify the current needs and its future goals for the network and to build a case around those requirements with input from stakeholders. For those areas where Ofgem is seeking to compare plans, we will need to work together to develop appropriate common assumptions to allow meaningful comparisons to be made.
- 4.6.3 Ofgem has suggested that the DNOs would 'commit' to achieving the outputs implied by the agreed building blocks and that they would be held to account in some way for failure to achieve those outputs. At the time the agreement is made, DNOs will be fully committed to achieving the required outputs but, equally certainly, circumstances are bound to change during the five year DPCR period that will require modifications to the assumptions within the building blocks. Any increases in regulatory risk of this nature will need to be adequately funded, either via the cost of capital or an appropriate mechanism.

#### **Question 7**

**What is the scope for developing additional outputs measures and how can these be incorporated into the price control?**

- 4.7.1 We support the principle and aspiration of understanding asset risk and criticality. For this to work in practice, there will be a number of key steps required. Companies currently have very different approaches to health indices and asset risk, and there will be significant challenges in creating an appropriate framework. There will need to be a balance struck between commonality and flexibility, to ensure that asset performance risk continues to be managed innovatively by the DNOs. Consideration will need to be given to costs that would be generated by new data and IT systems requirements. The experience of the transmission companies suggests that a period of data collection, cleansing and consolidation will be required before an industry-wide understanding of asset risk is available. Unfortunately, sufficient data would not be gathered in time for DPCR5 and therefore we do not believe it will be possible to introduce incentivised measures at this review. Instead, collaboration should be instigated, with the aim of developing an appropriate mechanism.
- 4.7.2 Whilst we support the continued development of measures for the utilisation of networks, they should be viewed as broad indicators of future investment levels rather than building block outputs. In this area there is good knowledge of specific network requirements which will provide more relevant indicators than high level measures.

#### **Question 8**

**What is the best way for DNOs to gain stakeholder input to their forecast business plans and how should Ofgem facilitate/incentivise this?**

- 4.8.1 We welcome and support increased focus on stakeholders and particularly the identification of stakeholder groups and issues on which they want to engage. We see less value in generic consultation to a wide range of stakeholders covering multiple issues and more value from more focused group discussions. However, we are working on a range of different approaches depending on the group or issues arising.
- 4.8.2 We believe that the benchmark for best practice should not be set retrospectively when evaluating our submissions. We would therefore like to maintain an ongoing and transparent dialogue with Ofgem about our activities, and would appreciate feedback following our August FB PQ submission before the September/October RRP visits so that we have enough time to incorporate Ofgem's views in our second round of stakeholder engagement.

## Question 9

### **Is the IQI and capex rolling incentive the best way to ensure realistic forecasts and efficient investment?**

- 4.9.1 The capex roller provides a risk sharing mechanism between customers and industry. The IQI scheme provides an incentive not to inflate capex submissions. As well as this, companies are aware that ex-post assessment of costs and projects may take place at regular reviews and hence there is little incentive to inflate costs to benefit from short-term revenue gains (and face reputational damage later on).
- 4.9.2 The IQI remains a useful tool to provide a level of flexibility in capex assessment, provided that the key guiding principle behind it remains as stated at DPCR4, i.e. "*...that companies who know they need to spend a lower amount of capex will find it more beneficial to choose the lower allowance, whilst companies who know they need to spend relatively more will find it more beneficial to choose the higher allowance ...*" (DPCR4 final proposals document, paragraph 7.74.)
- 4.9.3 However, the following changes (which have been proposed or implemented for water or gas) would compromise the above principle:
- Recalibrating the mechanism once DNOs have made their initial submissions and removing any opportunity to rebid.
  - Removing any 'smoothing' so that capex allowances are set equal to the consultant's (or Ofgem's) view. As well as running counter to the principle in 4.9.2, this would also go against a further principle set out in the final DPCR4 proposals, that the IQI mechanism should "*reduce the emphasis on Ofgem's or its consultant's view of the appropriate level of capex*" (paragraph 7.72).
- 4.9.4 Either of these changes would simply strengthen the incentive not to invest, which would be counterproductive in the longer term. We therefore advocate minimal change to the basic IQI mechanism at DPCR5.

## Question 10

### **How might the IQI and capex rolling incentive be improved or what additional measures could supplement them?**

- 4.10.1 One of the major innovations at DPCR4 was the introduction of the sliding scale or IQI mechanism. With the capex roller this provides (in theory) an opportunity for DNOs to choose their own risk reward trade off given knowledge about sources of uncertainty of the business plans and the proposed incentive properties. Experience from DPCR4 suggests for this to be properly effective, companies must have sight of the proposed mechanism when they are preparing their plans. This means that Ofgem and the industry need to have discussed the proposed framework at the very latest by the end of September 2008.
- 4.10.2 IQI-type incentives need to be applied to groups of building blocks with similar risks or consistently account/allow for potential substitution e.g. interaction of opex/capex incentives. The strength of the incentive needs to be appropriate for the building block or groups of building blocks to which it applies. We would in principle advocate application of the sliding scale to a network costs block as defined so far, together with appropriate capitalisation but need to work with Ofgem to develop a better understanding of the details.

### **Question 11**

#### **Should we aim to equalise incentives on network investment and business costs and how could this be achieved?**

- 4.11.1 We would like to see a balancing of the opex and capex incentives, although we believe that the current overall strength of the capex rolling incentive is about right, given that this incentive strength is primarily driven by a five year period of risk exposure before costs are transferred to the RAV. We have previously stated in other responses that we believe a five-year review period remains appropriate, albeit within a longer term context, given the pace of change in the energy sector and the uncertainties it faces.
- 4.11.2 The precise treatment of capitalisation and application of benchmarking and incentive mechanisms is key in determining the strength and nature of the incentives. Balancing of incentives can be achieved by ensuring that cost allowances are developed based on correct cost drivers and cost groupings. Although some costs hitherto classified as opex have been moved to the network costs, there are still several costs remaining in the business costs block that are driven by network activity, either directly or indirectly. These should be capitalised at a higher rate, ideally moved to network costs and benchmarked against the appropriate drivers. We have presented views on this already to Ofgem, and will continue to do so. Ofgem's capitalisation approach should include a 'bottom up' view of the economic nature of costs to inform relative capitalisation levels – see paragraph 4.4.2.

### **Question 12**

#### **Is the timetable realistic?**

- 4.12.1 The timescale for submission of the high level business plan template is testing for both Ofgem and DNOs, and we are concerned that this risks creating a piecemeal approach that does not seem to be the best way to approach such an important process. We recognise that Ofgem is not expecting all of the tables to be filled in initially, although we would like to understand the objectives of the exercise – specifically what the information will be used for.

- 4.12.2 The HLFBPQ tables are detailed and are different in scope to the RRP requirements, whilst the timetables for their completion overlap. Given the short timescales allowed, it is inevitable that DNOs' first submissions will contain draft or initial numbers which will be subject to change. Therefore, these figures should not be overly relied on in any preliminary benchmarking.
- 4.12.3 Looking further forward, we would like to clarify the timescales for submissions and challenges and linkage to development of the IQI mechanisms.

## 5 Finance

### Question 1

#### **Should Ofgem use its traditional approach to calculate the cost of capital or should other approaches be considered in order to provide the necessary incentives to invest?**

- 5.1.1 We are encouraged to see that Ofgem intends to maintain the use of a post-tax cost of capital and tax allowance approach. Stability and transparency of the regulatory regime are extremely important for investors.
- 5.1.2 We support the view that the CAPM framework should be maintained as a basis for the calculation of the cost of equity, although Ofgem must recognise that the CAPM framework does not take account of all downside risks for DNOs, in particular regulatory risk, and for this reason wider market evidence should be taken into account when setting the cost of equity.
- 5.1.3 The requirement to facilitate equity injections should be dealt with through the setting of an appropriate cost of capital that is high enough to encourage both debt and equity investment. Given the significant increases in investment programmes anticipated in DPCR5, it is essential that an appropriate level of equity is maintained, to avoid unstable, highly leveraged, financial structures. As with any transaction, DNOs will only be attractive to equity investors if the cost of equity is appropriate.
- 5.1.4 The suggestion that 'since DPCR4 the cost of debt has fallen' is questionable. It is true that low cost, long-dated, index-linked debt has been available in recent years. However, since the credit crunch began in August 2007, the cost of debt has increased and is now back in line with long term trends. It should not be expected that the cost of debt will revert to the low levels of the previous few years. Rather that the cost of debt has shifted back from unusually low levels to a sustainable long-term level. Since the credit crunch, monolines who previously insured, or 'wrapped', index-linked debt are now facing credit downgrades or even collapse and, as a result, the index-linked bond market is effectively closed to new issuance. In addition, the impact of the credit crunch is likely to continue, or worsen; and this is a risk which should be reflected in the allowed cost of capital.
- 5.1.5 Paragraph 5.10 states that Ofgem is 'interested in obtaining views on how, if at all, we should take account of MARs in setting the cost of capital'. As the consultation document also states, MARs reflect prices paid in the market. However, it should be borne in mind that there are many influences other than the cost of capital on transaction prices, such as the scarcity of assets being purchased and the availability of funds seeking such investments. Stripping out

the cost of capital implied in such transactions is not straightforward. In addition, highly geared transaction structures with a large proportion of index-linked debt entered into before the impact of the credit crunch could not be repeated in the current financial climate.

- 5.1.6 We strongly agree with Ofgem's viewpoint that a split cost of capital approach would not be appropriate at DPCR5. Such an approach would not improve the incentives for investment, lower the overall risk of regulated businesses or therefore reduce the overall cost of finance.

## Question 2

**In particular, should measures to protect DNOs from debt market volatility be considered, such as indexation of the cost of debt, or the use of reopeners at 'trigger' levels of interest rates?**

- 5.2.1 The application of debt indexation and/or debt triggers would serve to transfer the risk of movements in the cost of debt to customers. We believe that DNOs, not customers, are best placed to manage such risks and that debt indexation and/or debt triggers would therefore be inappropriate. There are also several practical problems with indexation/reopeners. Firstly, the cost of debt is not strictly observable; secondly, it is unlikely that a DNO's financing costs will move in step with market rates; and thirdly, the indexation of price limits in line with RPI already partially factors in changes in economy-wide borrowing costs. How this would fit with an indexation of the cost of capital is unclear. Capital markets are turning away from complex financial instruments and it would seem out of step for Ofgem to introduce such complex mechanisms at a time when the current focus is on better regulation and curbing the regulatory burden.
- 5.2.2 An unintended effect of the use of debt triggers could be that DNOs then arrange their financing in line with whatever benchmark Ofgem uses. For example, if the trigger was based upon returns on 10 year gilts, it is likely that DNOs would then only raise finance on a 10 year basis, which is unlikely to be the most efficient financing option. Financing is a matter for the DNO and Ofgem must take care not to encourage one particular approach.
- 5.2.3 On the subject of setting the cost of debt, it would seem an unusual move to turn away from years of regulatory precedent of using the sum of the risk-free rate and credit spreads to using yields on a suitable basket of utility bonds, especially given the recent consensus among regulators of a risk free rate of 2.5% and the use of this approach by the Competition Commission in the airports determinations. The proposed approach would be no simpler than the current approach – spreads and yields are equally available. We would not welcome such a move and believe that the importance of regulatory consistency and transparency should not be overlooked when considering any such change in approach.
- 5.2.4 If Ofgem's DPCR5 cost of debt is set below the cost of DNOs' existing fixed-rate debt, allowance for embedded debt costs or the costs of refinancing to achieve Ofgem's assumptions must be made. In addition, the precedent set by the Competition Commission's airports determinations is that it is appropriate to make allowance within the cost of debt for ongoing commitment, agency and arrangement fees, for which it concluded that the appropriate allowance was 15 basis points. However, in light of the credit crunch, issuance fees for both debt and equity have increased as higher premia are demanded by transaction underwriters.

### **Question 3**

#### **Should Ofgem make financeability adjustments or is this a matter for DNOs once the cost of capital is set?**

- 5.3.1 We agree with Ofgem that the cost of capital should be set at a high enough rate to allow DNOs to finance their operations without the need for additional financeability adjustments.
- 5.3.2 When assessing financeability Ofgem must reassess its definition of 'comfortably within investment grade'. If companies wish to raise significant amounts of debt, which is anticipated as capex programmes ramp up in DPCR5, they must be within the 'A' range of credit ratings. The floor for 'comfortably within investment grade' should therefore be A- if Ofgem expects DNOs to raise such levels of investment, especially in the current financial climate without the availability of monolines to credit wrap debt and where investors are more averse to risk and increasingly focused on the need for strong credit ratings.
- 5.3.3 Accelerated depreciation payments are not equal compensation for a lower cost of capital as they erode long term value for DNOs and the shortening of regulatory asset lives in DPCR4 has created longer term problems for DNOs. We support Ofgem's proposal to analyse the impact of this. However, we agree with Ofgem that rebasing asset lives would create financeability problems and the impact of any solution to this must be very carefully assessed in light of the need to provide greater certainty to investors and maintain current financial performance.

### **Question 4**

#### **Is it appropriate for Ofgem to be making commitments on investment and its financeability over the longer term?**

- 5.4.1 We believe it is important for Ofgem to take a long term perspective when assessing investment requirements as the assets that investors will be funding are long-lived and therefore require long term, predictable funding. Large fluctuations in regulatory parameters between price control periods increase risk and uncertainty, and ultimately threaten the appetite for investment. Ofgem must adopt robust and consistent positions and avoid unforeseen decisions which damage investor confidence. Stability is therefore a crucial factor in attracting funding for DNOs' growing investment requirements.

### **Question 5**

#### **Should a mechanism for ex-post adjustments for major changes in the tax regime be introduced and, if so, how?**

- 5.5.1 We welcome Ofgem's statement that it will maintain the approach of allowing for ex-ante tax costs with an ex-post adjustment for gearing. We do not believe that a mechanism for ex-post adjustments for changes in the tax regime is appropriate unless changes are of a material nature; DNOs should be able to manage this ongoing risk themselves rather than pass it on to the customer. The number of ex-post adjustments should also be minimised to avoid undue

complexity within the price control.

- 5.5.2 We believe that tax allowances for DNOs should be calculated as if the DNO were a standalone entity. DNOs should not be penalised for efficiencies gained from being part of a larger group. Furthermore, it is usual for payment to be made between group companies for the transfer of tax losses and this may therefore not result in a net cost saving for the DNO.
- 5.5.3 We question the consideration of capital allowances for non-operational capital expenditure by related parties. Recharges from related parties would include an element of depreciation for any 'distribution assets'. Therefore, if the capital allowances for related party assets are deducted from the DNO's tax computation, the depreciation in the recharge should also be added back in the tax computation, resulting only in a small timing difference in the tax charge.
- 5.5.4 Given that the calculation of deferred revenue expenditure should mirror depreciation policy, which will vary by DNO, it would be more appropriate for Ofgem to adopt DNOs' actual capital allowance policies and allocations, rather than a generic approach, when modelling the tax allowance.

#### **Question 6**

##### **Do respondents support the publication of a fully populated financial model?**

- 5.6.1 In principle Central Networks supports the publication of a fully populated financial model. However, DNOs should always have the option to restrict the publication of commercially sensitive information.

#### **Question 7**

##### **Should we calculate the DNOs' allowed revenues in a way that creates a smooth revenue profile over the course of the price control period and seek to reflect the level of costs expected in the last year of the control in order to reduce price changes from one control to another?**

- 5.7.1 The current approach to revenue profiling does not match capex investment and customers will therefore face a step change in prices at the start of DPCR5, partly as a result of profiling of returns in DPCR4. We would welcome moves by Ofgem to profile revenue in line with investment which would reduce the potential for large movements in prices to customers between price controls.

#### **Question 8**

##### **What factors should we take into account when determining the level of gearing to assume?**

- 5.8.1 We support Ofgem's use of a notional gearing level. However, we believe it would be unwise for Ofgem to set a cost of capital which is only achievable through a highly geared structure. The following factors should be taken into account when determining the level of gearing to be used:
- the need for regulatory processes and mechanics to be set in a predictable and transparent manner to avoid regulatory 'shocks',

- the vulnerability of highly geared entities to financial distress and the risk to customers associated with this,
- the anticipated significant investment required to finance large capital programmes during DPCR5 and the need for the cost of capital to be high enough to raise not only investment grade debt but also equity investment,;
- the requirement upon DNOs to maintain investment grade credit rating, and Ofgem's assessment of 'comfortably within investment grade'; which we believe should be based on a floor of A-
- the requirement to encourage DNOs to maintain financial flexibility to withstand financial shocks, such as freak weather incidents or the credit crunch, which can be restricted by highly geared models, and
- the impact of the recent credit crunch on the credit rating of entities with highly geared structures.

### **Question 9**

#### **Do respondents agree with the proposed treatment of net debt and gearing in ex post adjustments to tax allowances?**

5.9.1 We believe that Ofgem should not encourage highly geared structures and, as such, welcome the continued use of the tax claw-back above a specified gearing level in DPCR5.

### **Question 10**

#### **What are acceptable alternative approaches to calculating RAV additions; and, following recent market transactions, does RAV continue to reflect the underlying enterprise value of the business?**

5.10.1 We agree that the incentives between capital expenditure and operating expenditure are not equal and have commented on refinements to the building blocks approach. However, any significant change to the concept of the RAV must be very carefully considered to avoid regulatory shocks to investors.

5.10.2 Again, Ofgem should not be influenced by one-off transactions at premia to RAV, which we are unlikely to see repeated in the current financial climate. The reasons behind premia to RAV and transaction prices are complex and not simply a function of the cost of capital.

#### **Treatment of excluded services**

5.10.3 Currently, customer contributions received for new connections are deducted from load related costs, resulting in a deduction from the RAV. This treatment encourages DNOs to make very little or no profit on new connections as the more profit made, the greater the RAV deduction. This does not encourage competition or give transparency over new connections costs. Central Networks' proposed solution to this is to treat new connections as a ('relevant') excluded service, meaning costs and income associated with new connections do not impact the RAV.

5.10.4 Ofgem also needs to assess the current treatment of excluded services and the incentive properties that therefore result. This also needs to be considered alongside the role of DNOs to meet customer expectations and in the future potentially adopt a more proactive stance.

## **Pensions**

- 5.10.5 We look forward to Ofgem's separate consultation on pensions. We believe that the pensions pass-through arrangements should be maintained as, for companies which have closed their defined benefit schemes to new entrants, pension costs for defined benefit schemes are a result of historic decision making and outside the DNOs' control. Given that DNOs have very limited capacity to change current employees' pension arrangements, it is important that the pass-through continues for both normal and deficit contributions.

## **6 Process**

### **Question 1**

#### **Do you agree with the range of consultation approaches we intend to use throughout DPCR5?**

- 6.1.1 We support the range of consultation approaches and the timetable proposed and look forward to a clear and transparent consultation process. It will be important to factor in regular structured review sessions to maintain alignment and visibility across working groups. This could be achieved by Ofgem publishing the range of stakeholder groups it will be working with throughout the process and the approach it intends to take to review information across each group.
- 6.1.2 We recognise Ofgem's aspiration to reduce the consultative steps within the price control process. This has to be balanced against lessons learnt from previous price controls where limited dialogue can restrict the shape, measurement and understanding of desired outcomes for all stakeholders.

### **Question 2**

#### **Do you believe that we should utilise a consumer orientated challenge group to inform DPCR5?**

- 6.2.1 We support the involvement of customers to provide input, test and guidance for the DPCR5 process. It is important that these are representative of the DNO customer base i.e. covering regional, commercial, business, demographic and technical interest groups.
- 6.2.2 Care needs to be taken to ensure the proposed membership take a view on all subjects and are not single issue orientated which could unbalance and remove the group's ability to contribute and influence.

### **Question 4**

#### **Are there any other ways in which we should look to consult with interested parties?**

- 6.4.1 In order to consult further we believe customers need to be informed and provided with further information about distribution networks. Customers have a limited view of where regulated network businesses sit within the power supply chain, with confusion between retail pricing and the charging element for networks.

## **Question 5**

### **Do you agree with our approach to publish specific impact assessments for key 'important' decisions?**

- 6.5.1 Impact Assessments (IAs) are a useful tool for Ofgem to highlight modifications where stability in regulation may actually be of benefit compared to continual minor changes, and where change can bring real benefit.
- 6.5.2 With regards to using a value of carbon in IAs, it is right that Ofgem should use the methodology and values set out by DEFRA, but care must be taken to use an appropriate value within that subset. Under the range used previously, it is our perception that Ofgem consistently used values from the lower end of the range, which may have undervalued the cost of carbon. This point is of particular importance to Price Control Reviews, where a stated aim of Government, Ofgem and Industry, is to accommodate a move to a lower carbon electricity network.
- 6.5.3 It is important to understand that investment decisions in the energy industry can be based on life-cycles far longer than the proposed IAs cover (network investment may be considered as a minimum 40 year investment, for example). There is therefore the clear potential for the IA to give an inaccurate result, as the window of assessment is not long enough.
- 6.5.4 It would be useful jointly to identify, early in the process, the rationale for what constitutes key important DPCR5 decisions. This would assist communication and maintain co-operation throughout the review period.

## **Question 6**

### **Are there any other key milestones that you believe we should consider for DPCR5?**

- 6.6.1 Previous price controls have benefited from a September consultation paper prior to December issue of final proposals. We support the continual use of bi-lateral meetings with the Authority at key stages in the process and the continued publication of a 'September Update' document to maintain alignment and understanding prior to the final proposals.

## Customer Service Appendix

This appendix expands our views on the customer related issues raised in section 3 of the initial consultation document. It includes our views in answer to the questions raised throughout the text of the consultation document and supplementary appendix.

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## **1. Network Performance Issues**

### **1.1 IIS Target setting**

#### **1.1.1 Target setting summary**

- IIS has served to deliver improvements in network performance.
- The scope of data collection for quality of service is already vast and therefore any additional requirements should be limited to specific improvements and refinements to the target setting process that show clear benefits.
- Improvements could be made to HV disaggregation benchmarking where DNOs with unique network characteristics dominate the benchmarks resulting in benchmarks that are not realistic and achievable for the industry as a whole.
- Pre-arranged allowances should be linked to network investment activity.

#### **1.1.2 General**

The IIS target mechanism has acted as a driver to generate modest improvement in network performance (as measured by CI and CML) across the UK, which is consistent with the limited allowances provided during DPCR4.

The scope of data collection for quality of service is already significant and therefore any additional requirements should be limited to specific improvements and refinements to the target setting and performance assessment processes that show clear benefits.

Areas where target setting could be improved include:

1. greater transparency and assessment of pre-arranged allowances, and
2. better reflection of the ability for DNOs to make improvements, given the long-term investment horizon. This is particularly relevant where certain unique DNOs dominate and influence the HV benchmarks resulting in targets that are not realistic and achievable for the industry as a whole.

#### **1.1.3 LV Benchmarking**

We support the move to treat all LV faults together to remove any inconsistencies of reporting across the DNOs.

#### **1.1.4 HV Benchmarking**

When assessing the underlying performance of a DNO, this can be distorted by annual variability and it would be better to use data from more than one year. Using a period that is too short (e.g. 2 years) could lead to misrepresentative values where either 'good' or 'bad' years have been experienced. Conversely, a period that is too long can mask recent underlying improvements. We think a good balance would be three years which would also be consistent with the period used for DPCR4. This period should be proposed in the Policy Paper such that the approach is clear and not subject to 'cherry picking' once more data is available.

The disaggregated benchmarking approach used at HV has helped DNOs identify areas where they can make improvements. It has also helped identify the inherent

characteristics that are difficult to influence. We have concerns that there are a small number of disaggregation bands where benchmark parameters are driven by specific DNOs with unique network characteristics. This sets benchmarks that cannot be achieved by other DNOs in a cost effective manner and other than in the long term (+20 years).

For example in the UG2A and UG2B bands (representing longer underground circuits) the fault rate parameter is significantly influenced by EDF LPN. As LPN's network is composed entirely of underground cable it is cost effective for them to employ monitoring and condition assessment techniques that are not cost effective in other DNOs, which have to manage a greater mix of circuits across a wider geographical area. The absence of overhead line considerations allows greater focus on targeting of cable replacement and associated improvements in fault rate. LPN's circuits dominate these bands and influence the fault rates. It is not possible in the short term for other companies, where for historic reasons the inherent fault rates of underground cables are high, to make sufficient changes to meet the benchmarks. This places these DNOs at a disadvantage when assessing performance as part of the IIS mechanism.

Replacing the industry value of fault rates with a DNO's own fault rate would counter this disadvantage; but it would not provide any incentive for the DNO to improve. Therefore we suggest modifying the benchmarking process to introduce an improvement factor to drive improvement while recognising benchmark performance cannot be met.

Our suggested improvement factor creates a hybrid fault rate based upon a proportion of the DNO's own fault rate and the industry value. For example a 25% improvement factor would lead to a benchmark fault rate that was based upon 25% of the industry value and 75% of the DNO value.

Hybrid benchmark = (0.75 \* DNO fault rate) + (0.25 \* IND fault rate).

We believe that without significant long term investment it is difficult to change the performance of underground cables, and therefore this affects not only the UG2A and UG2B bands but any band that includes underground cables.

We think that for overhead networks it is possible to make network improvements to drive fault rates towards the industry average.

So to create a hybrid benchmark for other bands the improvement factor would only be applied to that part of the network which is underground.

The calculation would be:

$$HybridBenchmark = \frac{OHLen}{TotLen} x IndFR + \frac{UGLen}{TotLen} (25\% IndFR + 75\% DNOFR)$$

Where

OHLen = Overhead line length

UGLen = Underground line length

TotLen = Total line length  
IndFR = Industry fault rate value  
DNOFR = DNO own fault rate

This approach would facilitate the ability for DNOs and Ofgem to agree an improvement factor based upon the cable related investment allowances agreed as part of the building block analysis.

#### **1.1.5 EHV & 132kV**

The limited number of incidents and associated annual volatility of impact on performance suggest that longer term averages are more representative of underlying performance at EHV and 132kV. Even though a ten year basis is preferred, we accept that the seven years of available IIS RIG compliant data at the time of final target setting should be adequate to generate reasonable benchmarks.

#### **1.1.6 HV faults not attributable to current circuits**

We support the attempts to minimise the volume of incidents that are outside the benchmarking mechanism albeit that the materiality of non-attributables is generally small. We believe that there may always be incidents that cannot be allocated to specific HV circuits such as busbar faults and difficulties in allocation will be encountered where circuits are reconfigured. The 80% factor will act to drive DNOs to allocate faults to the latest configuration of circuits and potentially reduce the volume of non-attributables.

#### **1.1.7 Pre-arranged**

Ofgem's evidence suggests that a small number of DNOs were given pre-arranged allowances that are significantly above the performance being delivered. Even though in these limited cases there appears to be an anomaly, in general the allowances are reflective of the performance being experienced.

The level of pre-arranged interruptions is affected by a small number of drivers

1. the level of activity on the network,
2. the configuration of the networks and number of switching points, and
3. the extent to which live working techniques and generation are utilised.

Assuming that the network configuration and working methods remain at similar levels between price controls then the level of pre-arranged allowances depends mainly on one variable, the amount of activity.

Work volumes at HV and LV, both construction and maintenance, will drive pre-arranged interruption levels. It should therefore be possible to determine the ratio of historic work volumes for (capex and opex) and pre-arranged interruptions. Direct metrics for historic work volumes are not readily available and therefore we may need to consider the use of capex and opex spend as a metric to represent historic work volumes. Using spend as a metric is not a preferred solution as it blurs the distinction between input and output and raises issues where all companies are not equally efficient. Activity metrics are under development to aid cost benchmarking and these may provide a more sophisticated comparator than spend. Future forecasts could be based upon this

ratio provided no other influencing factors exist. Outliers can be prevented by identifying specific extraordinary historic activity levels such as pole replacement programmes and inadequate allowances can be avoided by taking due consideration of new drivers such as tree clearance to comply with ESQC Regulations.

We believe that the current arrangements, where pre-arranged interruptions are assessed at 50% as part of the IIS, are adequate and that there should not be a separate incentive mechanism. Provided that the allowances exclude outlier drivers then there should be no need for an adjustment mechanism.

## **1.2 Other IIS Issues**

### **1.2.1 Other IIS issues summary**

- Equalisation of Incentives – Greater understanding is required before this can be supported.
- Frontier performance – Allowance setting for frontier companies needs to avoid giving a guaranteed up-front out-performance reward.
- Underperformance allowance reductions – Target achievement assessments need more than one year's data to avoid weather volatility issues.
- Short interruptions should not be incentivised.

### **1.2.2 Equalisation of incentive rates**

In principle the equalisation of incentive rates with greater links to customers' willingness to pay makes good sense. However, it is not possible to give support to this without greater certainty of the target mechanism, thresholds for exceptional event exclusion and allowances for improvements as these will provide a better view of risk and opportunity.

### **1.2.3 Frontier performance**

We do not believe that frontier companies will be tempted to relax and allow their performance to drift. These DNOs will want to continue to maximise returns from the incentive scheme.

One option proposed within the consultation is for frontier companies to obtain up-front allowances and lower incentive rates in exchange for targets based upon current performance. These allowances would have to be set such that it is not viewed as guaranteed up-front outperformance reward, albeit that there is a likelihood that some of this may be given up in future years when current performance levels are not maintained.

### **1.2.4 Underperformance**

It is unclear how Ofgem would determine that a company had not achieved its targets. History shows that even with the exceptional event exclusion mechanism there is still annual variability driven by the weather. To counter this variability, the target setting methodology uses data from a number of years. We, therefore, do not believe it is fair to assess a DNO's achievement of targets at one particular point. This assessment is further complicated by the requirement to finalise DPCR5 proposals before the 2009/10 performance is known.

During DPCR4 we expect to invest around twice the QoS allowance provided and therefore will expect benefits to be realised. Priority is given to those circuits where greatest benefits can be gained and therefore targets should be met. Even with this focus on network performance other influences may dictate that the targets are not achieved and it does not appear reasonable that companies are penalised despite having made best endeavours.

### 1.2.5 IIS Audits

We support the move to introduce incident reporting accuracy assessments at individual voltages and we propose the following accuracy levels.

Voltage	Overall Accuracy	Initial stage Accuracy (smaller sample)
EHV & 132kV	97%	99%
HV	95%	97%
LV	90%	93%

We recommend that before making the change Ofgem seeks verification of the statistical confidence in the results. Calculating the accuracies at each voltage will lead to smaller sample sizes being used than currently used for the overall assessment. This smaller sample size may affect the accuracy.

A process could be built into the audit procedure such that where a sample failed to meet the required accuracy limit, then an additional percentage of faults are investigated to see if increasing the sample size has a significant impact on the result.

## 1.3 Exceptional Events

### 1.3.1 Exceptional events summary

- The mechanism should be focused on the exclusion of individual events to eliminate extreme weather variation from the assessment of underlying performance against targets.
- Reducing the number of exclusions will increase the volatility in underlying performance.
- Any changes made should be reflected in historical performance and the targets being set.
- A GS cap should be introduced reflecting the rising requirement for network investment activity.

### 1.3.2 Need for exceptional event exclusions

We firmly believe that the current exceptional event mechanism helps to provide a good first level of normalisation as part of the process to determine an underlying level of performance.

Even after exceptional event exclusion there is still a considerable amount of weather volatility remaining, which suggests that exceptional events are not being used

excessively.

Exceptional event exclusions need to be consistent and set at a reasonable level for the IIS scheme to work. Any reduction in scope of events to be excluded would only increase the volatility of performance results and thus the risk to companies.

### **1.3.3 Changes to exclusion mechanism**

Based upon the principle that the exceptional event exclusion mechanism is in place to identify underlying performance, it is not unreasonable to expect an average of 2 claims per annum from each DNO. Furthermore many of the claims will be related to the same weather event which, when coupled with growing concerns about greater extremes of weather, suggest that the current volumes are realistic.

We support the refreshing of the thresholds based upon the existing 8x daily average as this reflects the current levels of activity more accurately. Any increase in the thresholds (e.g. 10x) will introduce more volatility into annual performance assessments against IIS targets and therefore we suggest that the thresholds remain at 8x.

Any materiality threshold could appear to be a retrograde step and may reduce the fairness of the scheme. For example DNOs that have more automation and respond faster to events could be expected to have lower CMLs and may miss any CML threshold.

We accept that, in most cases, lightning events have a lower materiality when compared against severe wind storms. However there are parts of the country where lightning activity can be very high and for prolonged periods (as demonstrated in CN East during July/August 2006). The cumulative effect of this can have a significantly material impact upon performance and therefore excluding these events allows better assessment of underlying performance. Therefore we suggest that any materiality mechanism takes account of repeated incidence of lightning. One possible approach would be to have the materiality threshold based upon the cumulative effect of events that pass the exceptionality test – over, say, a rolling month period.

It is important that any changes to the exclusion mechanism are reflected in historical performance, benchmarking and target setting.

### **1.3.4 One-off events**

One-off exceptional events (e.g. caused by vandal damage, terrorism, severe flooding) are outside of the control of DNOs and therefore should continue to be treated as exceptional events. Currently there is a threshold of materiality which even when surpassed is not excluded from the IIS scheme, penalising DNOs for circumstances outside of their control. We propose that the materiality thresholds should be maintained to ensure that larger events are excluded, but that once an event passes the criteria for exclusion then the entire event is excluded not just the portion above the threshold.

### **1.3.5 Focus during exceptional events**

We can reassure Ofgem that the exceptional event mechanism does not reduce the incentive on DNOs to perform well. On the contrary, when severe weather is forecast the state of preparedness is heightened, extra staff are called into call centres and control rooms, pre-arranged work is suspended, additional craft teams and authorised switching persons are utilised and there is a general focus on speedy but safe restoration of supplies. DNOs have multiple incentives to restore supplies as quickly as possible in order to:

- provide good service to their customers,
- reduce the chances of further outages due to unavailability of sections of network,
- restore normal running as quickly as possible to allow the planned work schedule to go ahead,
- reduce any overtime payments associated with the exceptional events, and
- reduce GS failure payments whether associated with normal running or exceptional events.

### **1.3.6 Capping GS exposure**

We are expecting significantly higher levels of construction during DPCR5 than during DPCR4. This increased investment and network activity may lead to higher levels of network unavailability due to planned work. Under certain circumstances large construction projects can give rise to greater risk of second circuit outages (e.g. the failure of a second transformer when the first is being replaced). This could lead to long duration interruptions where there are limited alternative supplies. Even though the probability of this occurring is small, the risk increases as the volume of work grows. At present there is no cap on Guaranteed Standard exposure under these circumstances and there is some concern that this can introduce perverse pressures to invest uneconomically (e.g. by installing a third temporary transformer) to avoid the major interruption. We therefore propose that a cap of £200 per customer is introduced to limit the risk from these events.

## **1.4 Worst Served Customers**

### **1.4.1 Worst served customer summary**

- We support the aspiration to improve the service to worst served customers.
- We are working with the industry to develop a consistent definition and identification.
- Current systems do not support identifying LV interruptions seen by a customer and therefore either the definition should apply to HV and above or will require LV assumptions.
- Allowances should be based upon the actions to deal with a proportion (say 5%) of worst served customers over the period.
- Incentives should be based on focusing effort on worst served customers rather than enhancing GS2 or introducing a cumulative duration standard.

### **1.4.2 Introduction**

We support the aspiration to improve the service to worst served customers. We are working with the industry to:

- develop a consistent definition,

- clarify the identification process/counting methodology,
- focus on those circuits/situations where service can be improved cost effectively, and
- consider scope for and identify innovative solutions where appropriate.

We propose to establish a targeted investment mechanism that separately accounts for network improvements for worst served customers. We believe this would be more effective at helping worst served customers than tightening the general guaranteed standards as this just generates higher levels of compensation without necessarily driving improvements.

#### **1.4.3 Defining worst served customers**

In the consultation document, Ofgem refer to those with 'below average' performance as being worst served. This implies that half the customer base is worst served which is not realistic. We suspect Ofgem intended to suggest 'significantly below average' which would make more sense.

We believe that worst served customers should be defined as those customers that have a high volume of incidents (e.g. greater than 10 per annum). We look forward to working collaboratively to establish a clear definition so that investment for improvement can be targeted on a consistent basis across the UK. We will also need to agree whether events beyond the DNO's control should be excluded from a count of interruptions such as exceptional events and third party faults.

#### **1.4.4 Improving service for worst served customers**

Worst served customers can be affected by incidents that arise at any voltage level. This can make it difficult to determine which network to improve. Where faults mostly occur at one voltage level it is possible to target improvements by identifying a consistent cause. For example it may be possible to refurbish a HV overhead spur, provide more upstream protection on other spur lines, or replace a deteriorating LV Consac cable.

However, where customers experience faults from a number of voltage levels it becomes difficult to target specific improvements as there are many causes leading to the poorer service. Similar problems exist where faults occur mainly at one voltage but with a variety of causes suggesting a variety of possible solutions. This may result in costly multi-approach solutions that may only benefit a handful of customers. There is therefore a balance to be established between making improvements and cost effectiveness. As addressing the needs of worst served customers is rarely cost effective a new approach must be developed such as a dedicated capital allowance.

#### **1.4.5 Identification of worst served customers**

DNOs' existing control systems enable good identification of customers affected by incidents on the HV, primary and 132kV networks. Loss of HV supplies means that all the customers fed from HV substations are affected.

Difficulties arise at LV. Historically, control systems have not been configured to record the sectionalisation of the LV networks and connection phase data has not always been collected which means that when a fault occurs on part of an LV feeder it is difficult to

systematically identify the customers affected. Retrospectively collecting this information and changing the systems to collect additional data going forward would incur significant cost while only offering potential benefit to a small number of customers.

Since there are technical difficulties at LV, one approach could be to target worst served improvements at HV and above. Alternatively it could be possible to make assumptions at LV that relate all interruptions to the HV transformer, which at least would enable the identification of HV transformers with multiple faults on the associated LV circuits. This initial view would not properly represent the actual number of customers affected but may still provide a useful indicator of those substations with high volume activity. These could then be investigated in more detail.

#### **1.4.6 Incentivising action on worst served customers**

Tightening the guaranteed standards is unlikely to provide the necessary driver to improve service to worst served customers as while worst served customers will undoubtedly qualify for payments for guaranteed standards failures, these cover a wider range of customers than just those who are worst served. In most cases, the cost of solutions would be in excess of the payments and there is a risk that such changes would only lead to the creation of an excessive volume of payments with an associated administrative burden.

We propose that a separate mechanism is established that operates in a similar fashion to the AONB mechanism during DPCR4. Since the scale of the issue is not fully clear due to limited LV information, and this is a new area of focus, the allowances could be based on a broad measure, for example the number of customers experiencing more than 10 faults per annum. A target for reduction could be set at say five percent of these worst served customers. DNOs would then plan for targeted improvements during DPCR5 and the actions carried out would be separately accounted for.

## **2. Customer Service Issues**

We believe that there is scope to provide better information to customers, for example we are seeking to improve the information we give customers about our future capital plans.

### **2.1 Telephone Response**

#### **2.1.1 Telephone response summary**

- The telephone survey should be centrally administered to ensure consistency.
- We support the pilot of a question to determine customer satisfaction with DNO communications during an outage.
- Existing Key Measures do not need to be incentivised as these provide context data rather than additional measures of customer satisfaction.

#### **2.1.2 Customer satisfaction survey**

We consider that the telephone survey should remain centrally administered as this will ensure consistency.

There may be value in adding questions to the telephony survey which cover customers'

satisfaction with how DNOs communicate in general rather than being purely limited to their telephony performance. This may be particularly useful to see how best practice items relating to communication identified in the discretionary reward are being adopted and implemented across the DNOs. Such questions must be framed to allow consistency of treatment between DNOs.

We intend to continue to carry out our own surveys relating to our own specific communication initiatives such as the Live Network Map on our web-site. Recently we commissioned research on the use of our website by ethnic minority customers and their specific needs.

We have no objection to sampling customers that received an automated answer, however these customers are given the option of speaking to an operator so they have not been totally excluded from the existing survey.

We support the simplification of the attributes assessed to the three questions suggested.

### **2.1.3 Additional Questions**

Ofgem has proposed the following possible additional questions for the survey.

1. If your electricity supply was interrupted, how satisfied were you that your electricity supply was restored as soon as possible?
2. How satisfied were you with the way DNOs communicated with you while your supply was interrupted? For instance, were you adequately updated of their progress in restoring your electricity supply?

The first question raises concerns as to how well placed customers are to judge the practicalities affecting duration. It would be difficult to determine from their answers whether the dissatisfaction is due to customer expectations being unrealistically high or due to poor performance by DNOs. There is a risk that this question would incentivise DNOs to overestimate restoration times which would be a retrograde step. We do not support the inclusion of this question.

However the second question reflects something the customer is well placed to judge, i.e. how satisfied they were with ongoing communication during a fault. We believe this would encourage DNOs to be proactive in their communication with customers during outages and therefore we support the inclusion of this question.

We support the use of a pilot scheme to trial the new set of questions in the customer survey and suggest that the results of the pilot should be shared for debate to ensure that the additional elements add value before being included.

### **2.1.4 Key measures**

The use of physical data in incentives could be problematic as this often reflects the features of different types of call handling systems. Incentives should not be so prescriptive as to dictate system choices or simply reward the company with the most

recently implemented technology. This could lead to decisions which are not cost effective overall as some features will only be of use during exceptional events and offer less flexibility for routine call handling.

Physical data may not add anything more to evaluating customer service than sampling customer opinions. For example if a customer's lights come back on when they are in the process of calling the DNO then they may put the phone down resulting in an unsuccessful call. It may be too simplistic to infer that this represents a measure of customer service. An alternative may be to ask about previous recent difficulties when trying to contact a DNO in the customer survey.

We agree that key measures KM1, KM2 and KM3 should not be part of the incentive scheme. This information may be useful in putting the call handling performance and costs into context but inclusion of these would effectively be specifying the 'right' ratio of calls answered by call handler or message. This is for DNOs to determine based on their understanding of customer requirements.

We do not believe KM4 (speed of response) should be included in the incentive, since speed of response is only one element affecting customer satisfaction, and is unlikely to be the dominating factor. Inclusion of this would lead DNOs to improve systems or employ more call takers at increased cost with no proven customer benefit.

Similarly KM5 (unanswered calls) reflects too many different aspects of the call taking system and environment to be a useful measure.

## **2.2 Discretionary Award**

### **2.2.1 Discretionary award summary**

- The judging process, which is key to the success of this award, can be improved in terms of the time allowed, composition of the panel, direction given to the panel and verification of submissions.
- There should be clearer terms of reference to define each category and what successful DNOs will need to demonstrate.
- There should be more categories as this will help provide clearer terms of reference for each category.

### **2.2.2 General**

Discretionary awards should provide a mechanism to reward achievements and motivate innovation or improvements in areas where metrics and targets are not really appropriate. For example it is difficult to quantify how innovative a company has been or the degree to which they have 'gone the extra mile' in numerical terms. Therefore this type of award relies heavily on human judgement to assess DNOs achievements and a suitable number of categories should be used so that the evaluation process is not confused by having to consider too wide a range of issues. Without a robust framework and process these awards will not produce the desired effect and risk having a de-motivational impact. We think this can be avoided by adopting the following improvements.

### **2.2.3 Judging**

We believe that a robust judging method is essential to the success of a discretionary award and that the current judging method needs to be improved. An independent chair would need to ensure that the process gave sufficient weight to the representatives for each issue.

The judging panel needs to:

1. reflect the concerns of the majority of DNO customers,
2. allow for regional representation as customers concerns can vary according to DNO specific aspects, and
3. fairly represent the issues being judged with appropriate expert customer representatives.

Customer representatives could be included in the judging panel, or replace the panel entirely though care would need to be taken to ensure the customer sample was representative and not biased towards or against any particular DNO. Inclusion of regional representatives may help in achieving this.

More time should be allocated to the judging process so that DNOs can explain their submissions fully.

Given that Ofgem audits IIS and RRP returns to ensure they are correct, some auditing of award submissions may be useful to ensure these accurately reflect what happens in practice.

### **2.2.4 Categories and Award value**

We believe that while addressing the judging issues are of prime importance, there is merit in increasing the number of categories within the reward. This would assist the judging process as it would simplify the range of issues evaluated within each category. This would allow better comparison between the DNOs and would mean judges would be more likely to evaluate issues relating to their expertise.

The regulatory structure and incentive frameworks for distribution businesses provide limited incentives to spend on customer service other than network performance, therefore the discretionary award should involve a significant sum to reflect the degree of initiatives and work carried out in this area. We believe there is scope to increase the total value of the award to ensure that these are still significant financially, for example four awards of £400k-£500k each. The final results of the consumer survey can be used to determine how the categories should be reshaped. However, as an initial suggestion, an area to be rewarded could be the performance of DNOs during exceptional events. Given the increasing emphasis placed by customers on environmental issues this could be removed from the corporate and social responsibility section and form part of a separate environmental incentive.

The value from winning the award is not just financial, but motivational, therefore it would also be useful to consider more awards even if the financial value were small – e.g. 10 awards of £100k each.

## 2.3 Guaranteed Standards

### 2.3.1 Guaranteed Standards Summary

- We need to be clear what guaranteed standards are trying to achieve.
- Changing from 18 to 12 hours will introduce further cost to DNOs and customer willingness to pay needs to be confirmed. Some exceptions should be considered.
- A total duration standard would be too complex to administer, creating a compensation machine without driving improvements to network performance.
- Business customers have the ability to choose to fund specific mitigations for their own circumstances and risk of loss of supply and therefore do not require increased GS payments.
- GS audits are unnecessary.

### 2.3.2 What are Guaranteed Standards for?

We need a common understanding of the purpose of guaranteed standards as this impacts our view on how they should be developed. We believe they exist to provide a 'backstop' to DNOs performance reflecting a standard which the DNO should be able to meet. Other incentives then motivate DNOs to extend their performance beyond the minimum. Guaranteed standards were intended to incentivise DNOs to improve their service, but were never intended to compensate customers for consequential loss. Therefore we need to be careful about the use of the word compensation as DNOs are unlikely to ever be in a position to provide full financial compensation to customers for all the inconvenience and lost working time. Indeed, it is rare for any commercial business to compensate its customers for consequential loss.

If we believe Guaranteed standards relate to what DNOs can reasonably be expected to achieve then the design of guaranteed standards should consider the technical and practical issues which impact on DNOs ability to deliver. Less emphasis should be placed on customers' expectations because customers are unaware of the technical and practical limitations. This is reflected in the discrepancy between the payments under normal and severe weather conditions that does not reflect the experience of the customer, but the ability of the DNOs to restore supplies. This is not to say that DNOs do not aspire to meet customers' expectations, but rather to acknowledge that there are technical limitations.

We believe that the standards still cover the right areas and have payments set at the right levels.

### 2.3.3 GS2 – 18 hour restoration

We aspire to reduce the duration of all incidents and have taken practical steps to achieve this by investing in technology and changing our fault management processes. We feel we are now at a stage where there is limited opportunity to make further improvements without overcoming practical hurdles such as greater night-time working and significant additional cost. Any changes to GS2 should therefore take due note of the costs of additional resources, increases in generation and enhanced cover outside normal working windows. Without sufficient allowances DNOs will have limited scope to improve, resulting only in significant increases in compensation payments.

The inherent characteristics of network performance are based on time of repair for loss of less than 1 MW (ENA planning standard P2/6). Whilst we are investing in remote control and automation to improve restoration times to customers whose network can be restored without repair, the majority of long duration outages relate to customers whose restoration depends on repair. There have been limited technological developments to speed up repairs since cold mechanical resin based technology replaced soldered hot compound jointing. Therefore DNOs' only likely solution to reduce repair time is to increase resources, for example sending multiple jointers to a fault where more than one joint is required.

An unintended consequence could be increased levels of complaints for noise disturbance where teams would be required to work through the night to restore supplies.

It may be possible to limit the negative consequences of these standards by introducing exemptions that build on the scenarios used for clock stops. For example:

1. Safety reasons – if for some reason it is not possible to continue to work safely then this should not be considered a failure.
2. Social nuisance of continuing work at that time – whether this is due to noise, or causing problematic obstruction.
3. Factors beyond DNOs control – e.g. where access can not be obtained to sites or work is prevented by third parties such as the fire brigade.
4. Doing the work at night lowers workforce efficiency and requires higher labour costs

More work needs to be done to determine if customers are willing to pay for the additional costs and suffer the disturbance that would be incurred to achieve the 12 hour standard.

#### **2.3.4 GS2A (+) Cumulative duration standard**

The purpose of the GS arrangements is to incentivise DNOs to deliver good service. This implies a scope to identify failings and that it is possible to target improvements.

The suggested total duration standard (particularly at the duration of 12 hours) could lead to a payment being made for a customer experiencing an LV fault lasting 6 hours and a HV fault lasting 6 hours each of the underlying causes being resolved at the time of fault. Such low levels of activity on circuits will be very difficult to predict and almost impossible to effectively target with some form of proactive improvement.

We believe the additional costs in terms of setting up additional systems and staff to process the significant amounts of data required to determine whether such a standard has been breached are disproportionate to the benefit to the customer from this standard. From our experience administering the existing guaranteed standards, we believe that the definition of this standard may be hard for the customer to understand. This standard would need to replace the two existing standards for duration and multiple interruptions otherwise customers would be paid twice for the same failures.

The total duration standard implies that the customer is equally inconvenienced by five two hour interruptions as two five hour interruptions which may not be the case. Also, our customers tell us that they understand and accept that during periods of bad weather our performance will be affected. This implies that to be objective, interruption durations during severe weather should be weighted differently to those during normal conditions. Given customers are more accepting of planned outages, as acknowledged by the 50% weighting for CMLS and CIs in the Interruptions Incentive Scheme, then these should either be excluded totally from a total duration standard or only weighted at 50%. Similarly DNOs should not be penalised for incidents due to interruptions on other systems (National Grid, Other DNOs, IDNOs).

This proposal will result in significant increases in the volume of compensations payments without necessarily driving any improvements in the network. We do not believe that this standard would change behaviour, nor will it enable focus on worst served customers. However, it would be likely to create a compensation culture with a high volume of payments and associated overhead costs of administration. We believe our resources would be better used improving customer service.

### **2.3.5 Business customer compensation**

Business customers have greater scope to consider the security of their supplies and can factor in stand-by generation or UPS installations as part of their specific business criticality and continuity risk assessments. Guaranteed standard payments should therefore not be an alternative to proper business insurance or contingency arrangements.

To reiterate our earlier point, the guaranteed standards were never intended and should never be designed to cover consequential loss and therefore the mechanism exists to incentivise DNOs to improve their service not to compensate.

We support the view that currently technology does not allow for varying degrees of service on a single network, however as networks change to incorporate more distributed energy it may be possible for businesses to contract alternative supplies from these generators and establish arrangements with DNOs to enable localised restoration.

### **2.3.6 Guaranteed Standard Audits**

We support Ofgem's analysis that guaranteed standard audits are unnecessary. The scope of IIS auditing has progressively grown to include non-reportable events and short interruptions so Ofgem should have high confidence in the accurate and complete reporting of incidents. Cross checking GS payments against this data should suffice in the assessment of GS performance.

## **2.4 Customer Redress and Complaints Handling**

We expect the introduction of customer redress schemes and a complaint handling standard will fully satisfy customers' needs in this area for DPCR5. Indeed introducing the guaranteed standard on top of the new complaint handling standard would introduce unnecessary duplication and complication.

We believe a guaranteed standard for complaint handling is not necessary. The benefit of having symmetry with gas complaint handling standard may be overestimated as the number of people who complain to both gas and electricity companies on a regular basis should be small. As the Gas complaint standard has only been recently implemented it is too early to say whether this is a good model to adopt. We believe that as long as our processes for dealing with complaints are clear and fair they do not have to be the same as those for gas companies.

Central Networks has already demonstrated good practice in addressing customer complaints. We already operate a voluntary internal standard that requires us to provide a substantive written response to customer enquiries within five working days and this is to be extended to e-mail. We make payments to customers for failures against our standard.

We are concerned that introducing a more prescriptive and restrictive scheme would lead to 'automatic' compensation i.e. making discretionary payments to customers to avoid a failure against this standard rather than really thinking about and improving customer complaint resolution. There have been instances where people receiving such payments encourage others to 'try their luck' and it may end up being an incentive that encourages customers to complain rather than motivating DNOs to improve their complaints handling process.

Complaints may duplicate areas covered by existing standards e.g. having been paid under guaranteed standard for loss of supply then raise the issue as a complaint and expect further redress.

There may be issues around defining when a complaint has been resolved. For example, if a customer has quality of supply problems, resolution may require work on the network which has to be scheduled as part of an optimised investment plan. At what stage is the issue considered resolved, when work is planned, scheduled or carried out?

## **2.5 Consumer representation**

There will be a need for continuing customer insight through the DPCR5 process, from additional research undertaken by the DNOs or Ofgem and through the stakeholder engagement process.

If Ofgem set up a consumer panel and/or technical challenge group then considerable care will be required in selecting representatives so that:

- complex issues are considered by technically able people,
- the full range of customers are reflected such that all customer types are represented, and
- the group can represent issues and concerns from all regions.

One possible area for research could be about differences in expectations between rural and urban customers.

## **2.6 New customer service incentives**

The current incentive framework covers the areas of most importance to customers. However given the increased prominence of the environment as an issue concerning customers it may make sense to separate this area out from the corporate and social responsibility element of the discretionary reward. We suggest that either a separate discretionary award is created for environmental issues which runs every year or an element recognising leadership and

innovation in incorporated in a wider environmental incentive package which complements the losses incentive.

We are considering the development of additional incentive mechanisms in some specific areas. These are in the very early stages of development and we will update Ofgem as our thinking progresses.

### **3. Connections**

#### **3.1 Competition in Connection**

Connections within Central Networks are provided by our affiliated agent Energy Services. Energy Services have a vision to be the leading connections provider and to differentiate their products through customer service. In order to achieve this objective, we believe that costs associated with competitive activities should be removed from the price control and therefore have no impact on the RAV.

We support the existing voluntary and licensed standards around competition in connection but do not believe that there is scope to increase the activities open to competition in connection. For those parts of the new connections market where practical issues prevent a fully competitive market there should be safeguards to ensure that levels of performance and margins are appropriate.

Ofgem propose different actions they could take to support an emerging competitive market. We feel that these proposals are best directed at the areas where competition is unlikely to occur, such as one-off domestic connections. This is to ensure that levels of service are safeguarded in these areas where the benefits of competition will not develop. We believe that the front-end of the connections process (i.e. the application and estimate) for the customers not impacted by CiC is covered by the existing guaranteed standards. If it were considered necessary to ensure protection of service for these customers, we would support a collaborative process to consider how best to reinforce these standards.

#### **3.2 Pricing issues/National Schedule of costs**

Ofgem suggests that where competition is unlikely to develop, standard pricing mechanisms could be used to protect customer interests. We believe that a regulated national cost or a schedule of costs would not be practical due to issues of volatility of cost for materials and contractor prices as well as DNOs having different cost bases and delivery structures.

It may be more appropriate for DNOs to have an obligation to provide a range of standard connection costs (or price schedule) for certain customer groups, where differentiation in cost of connection was demonstrably small. For example, single phase services in urban areas would be too small to attract competition in connection but would have relatively little variation in costs. Rural customers on the other hand would be better served by a bespoke quotation.

With larger or more complex schemes (e.g. rural vs. urban), we feel that the customer benefits from bespoke designs. Without this a standard price would cause large cross subsidy between these customers due to the size of variation in cost of providing the same size connection from one customer to the next.

The Competition in Connections Review is driving improved cost transparency proposing all DNOs include detailed cost breakdowns for all connection quotations also separating contestable and non-contestable elements. This will enable more understanding of the make up of the connection costs and also allow comparison of quotes with competitors.

#### **4. Miscellaneous**

##### **4.1 Consumer First Research & Willingness to Pay Survey**

We welcome the opportunity to comment on the quantitative research findings in June 2008. We agree that this should inform the evaluation of resilience and flooding expenditure and we are hoping that the stakeholder engagement process will provide a more rounded view on these items.

One potential problem for the willingness to pay work is that customers may not be able to understand the context in which to evaluate their preferences for cost increases that relate to improvements in service. For example it is likely that due to the age profile of assets, costs will increase simply to maintain the same level of network risk. The recent rises in retail prices will complicate this issue further as customers are not clear on the proportion of their bills that relates to DNO costs. (We are attempting to improve customer understanding of what we do and why. We intend to increase visibility of our DPCR5 investment plans to help customers see how this work will deliver benefits to them.)

Customers' willingness to pay for improved service may change if the costs associated with baseline performance have also increased. For example, if customers are paying £60 per year for the current level of service they may be happy to spend another £5 for improved service, but if the costs of providing the current level of service rise above £70 then would they still be happy to pay an additional £5 for the same service improvements?

We need to question customer beliefs on increased compensation and whether the customer is willing to fund the additional costs to increase compensation or considers as we do that DNOs should not be a proxy for insurance.

Given the emergence of environmental issues as a key concern for customers it would be useful if this were reflected in the next survey. Currently it is not clear whether this will provide useful information on environmental issues.

##### **4.2 Power Quality**

We support Ofgem's view that the costs of the proposed changes regarding power quality would far outweigh the benefits to customers. The vast majority of customers find power quality acceptable. The limited number of issues raised by customers on harmonics, flicker and unbalance suggest that tighter mandatory limits may lead to investment where in reality there is no problem to solve.

##### **4.3 Areas of Outstanding Natural Beauty**

We consider undergrounding to be an important aspect of our Corporate Social Responsibility to improve amenity for residents and visitors to areas of outstanding natural beauty (AONBs) and National Parks (NPs) through reduced wire-scapes. Whilst overhead lines are a necessary

means to distribute electricity cost effectively (particularly in rural areas) we take customer views into account and support the removal of the most visually obtrusive lines.

We support the continuation of this initiative and plan to invest up to the levels allowed by Ofgem with a view to removing the lines that stakeholders believe are most visually obtrusive. We believe that targeting 1.5% of overhead network lengths within areas of outstanding natural beauty and National Parks is a reasonable volume, however we would like to see the cost caps increased to more realistically represent the cost of undergrounding.

So far, out of 66 projects identified and submitted to us, 19 have been rejected due to cost or technical limitations. The main problems encountered are the cost of laying underground cables in difficult terrain (e.g. granite) and problems associated with shared infrastructure with British Telecom. We suggest that the allowances should be increased so as to be more reflective of the conditions encountered.

We recognise that allowance caps provide some protection for customers from inefficient expenditure but there could be scope to incorporate some measure of the numbers of customers benefiting from such work in terms of who might see the improved amenity (i.e. customers who reside in villages or number of visitors) in order to maximise the initiative's attractiveness and potential. We would also appreciate the ability to consult with AONBs on their perceived trade-offs in selecting the most appropriate schemes, irrespective of cost caps.

The other main area of concern is shared infrastructure, i.e. where support is shared with British Telecom or street lighting. A number of projects have been rejected so far due to shared infrastructure with BT. Customers won't benefit from our efforts to underground electricity networks if poles are then adopted by BT and left in situ, but BT do not have incentives to co-operate with DNOs as evidenced during discussions over projects in Lincolnshire Wolds. We would welcome assistance from Ofgem in encouraging co-operation across regulatory bodies to ensure common objectives and support for undergrounding.

We actively seek to address noise issues by changing equipment or installing noise reduction arrangements and therefore noise should be considered as a separate entity in its own right. We suggest that there would be little benefit in extending visual amenity funding outside designated areas due to the potential deluge of requests by customers seeking the removal of poles and wires from their property which could have a negative impact on both the quality and efficiency of our customer service. Therefore we do not believe that the scheme should be extended to cover noise or expanded beyond AONBs.