Rachel Fletcher
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9 Millbank
London
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23 June 2008

Dear Rachel

DPCR5 INITIAL CONSULTATION

EDF Energy welcomes the opportunity to respond to this consultation.

This response is being submitted on behalf of all of EDF Energy's businesses, including in particular our three licensed distribution companies: EDF Energy Networks (EPN) plc, EDF Energy Networks (LPN) plc, and EDF Energy Networks (SPN) plc. I confirm that this response can be published on Ofgem's website.

First of all, we would like to commend Ofgem for producing a comprehensive document which addresses nearly all of the pertinent issues. In this letter, and in our attached response, we set out:

- the key areas of context that make this review different from earlier price control reviews;
- specific issues relating to the costs of financing DNOs; and
- comments on areas where Ofgem has previously expressed an opinion and that could significantly impact DNO cash-flows, but which were not discussed in your consultation paper.

The Overall Context

This DPCR comes at a time when questions are being raised over the future role of network operators, and what society expects from them. These questions arise for a number of reasons:

- we are already seeing a number of significant changes affecting the energy industry;
- there is substantial uncertainty – not least over the extent to which future electricity generation will be connected to local distribution networks;

- we are facing a need to increase investment in networks as components come to the end of their life and the capacity of the network (especially in the south east) has to be increased to accommodate increasing demand; and

- Ofgem has itself acknowledged that a regulatory shift is needed away from the previous overriding focus on squeezing out costs from regulated monopoly network operators.

Changes are already being observed in the social environment for distribution network operators. Society's attitude to energy is changing, not just in response to high wholesale oil/gas prices but because of a growing awareness of mankind's impact on the environment. Changes arise also because our customers' priorities and willingness to pay are evolving, and changes are required in response to the tragic incidents that we have experienced over the last 18 months.

This DPCR also comes at a time of great uncertainty, particularly about how society will react to incentives to deliver more sustainable sources of energy. Some argue that the solution lies predominantly in more decentralised sources of electricity and heat. EDF Energy believes that choices of how to deliver a more sustainable energy supply must be based on sound economics if we are to meet the challenge without undermining living standards and international competitiveness. Our analysis indicates that such rational economic decisions will result in a much smaller increase in decentralised electricity and heat than is generally assumed.

Within this environment, there is a valid debate about the role of network operators and what society expects from them. The current scope and role of the DNOs is essentially a product of two things: the decision taken at privatisation not to disturb the boundary between electricity transmission and distribution; and the separation of public electricity suppliers' activities into supply and distribution.

Aspects of those decisions should be reviewed because:

- Increasing levels of DG/DE could require DNOs to manage two-way power flows, and may even require the development of a distribution system operator function.

- New and significant uses of electricity may develop, such as electric vehicles.

- Where energy efficiency measures have a network impact, DNOs may be better placed than others to discuss such issues with customers. Examples of such efficiency measures include demand side management, energy storage, DG support, power factor, harmonics, and smart metering.

- There are potentially new roles for DNOs in supporting improvements in overall energy efficiency and sustainability, for example by facilitating development of heat and cooling networks.

The focus of regulation also needs to change. Previous reviews, including the last one, have focused heavily on cost reduction in order to drive out the inefficiencies inherent in former nationalised industries. However, it is clear that this approach has more than run its course: DNOs are now mostly overspending their operating cost allowances and the frontier shift asserted by Ofgem at DPCR4 has been shown to be unachievable. Alistair Buchanan has rightly referred to the lemon having been fully squeezed.

Adjusting the focus and role of DNOs will be challenging, and will need some explicit support through DPCR5. The historic focus on cost cutting has had an impact on the type of expertise available within the DNOs. They have become very operationally focused and have been forced to shed their more intellectual and strategic resource. As a consequence, aggravated by the well-understood age profile issue, they are not best positioned to deliver new services and to manage change.

This problem can be overcome but the necessary resource will take time to rebuild: and the price control can help. The bold introduction by Ofgem of the IFI scheme has, for companies like ours that have embraced the opportunity, already delivered benefits in terms of developing intellectual resource. DPCR5 needs to build on this.

At DPCR4, Ofgem recognised the start of a long period of increased investment by the DNOs, led, not surprisingly, by EDF Energy, as we serve the most dynamic and growing economic region in the country. This investment focus needs to continue through DPCRs 5 and 6. Ofgem should not be concerned about the apparent underspends in the early years of DPCR4, which is mostly a profiling issue (capex allowances are flat but our plans always showed a rising profile of spend). Our contractual framework for increased investment levels took longer to put in place than envisaged but, now that it is established, we are well placed to continue to deliver the necessary investment.

Specific Financing Issues

Recent years have seen the emergence of very highly leveraged financing structures. EDF Energy, like its parent EDF SA, is a long-term player that strongly believes in the role of equity to shield consumers from risk – provided, of course, that risk is appropriately remunerated though the cost of capital and incentive structure. We therefore have no intention of seeking short-term gains through highly geared structures. We fully understand Ofgem's concern about the high premiums which have recently been paid for utilities. However, Ofgem should not be overly concerned as there are many reasons why such prices have been paid, including, most importantly, investor over-optimism.

There can be other factors in play too. Clearly, extreme levels of gearing in the holding company, outside the constraints of the regulatory ring fence, can create significant (but risky) tax advantages, and the use of index-linked debt can inappropriately release value which should be retained within the regulated business to fund the replacement of matured debt. But neither of these is a valid reason for believing that the regulatory cost of capital is too high.

In recent years, there has been robust debate on the role that financeability adjustments should have in price controls, and we note that Ofgem wishes to revisit the decision to accelerate regulatory depreciation for the DNOs taken at DPCR4. As Ofgem already assumes an element of retained earnings in its financial modelling, the principle of using equity to finance investment is already established to some degree.

The key question for this review is whether the role of equity should be widened – even to the extent of assuming equity rights issues in order to meet appropriate cash ratios. We believe that equity can, over time, play a greater role. However, it will take time for the investment community to get used to a changed paradigm which could adversely impact the real cost of equity: so we recommend only limited movement in this direction at this time.

EDF Energy does not believe that distribution should be a zero-risk activity. We well appreciate that consumers expect us to manage a portfolio of risks on their behalf in return for the cost of capital and incentive benefits. We are expert in managing these risks and do not see a case for passing them on to customers, who are far less well equipped for this task. For this reason, other than where the risk is one that we cannot manage, we are not in favour of additional risk transfer mechanisms, such as debt cost pass through/debt triggers, or commodity price adjustment mechanisms.

We are also strong believers in the power of incentive regulation to deliver what our stakeholders want. We have strongly embraced Ofgem's call to consult more with our stakeholders and we support Ofgem's willingness to pay for customer survey work. We see these activities as essential features of regulation because, in order to protect the interests of customers, both companies and regulators need to find out what those interests are.

Where our customers express a wish for us to change our priorities (for example , by paying more attention to our impact on the environment), then we are happy to meet the challenge and to accept a sensible level of risk commensurate with appropriate outperformance opportunities.

Important Omissions

As we noted above, the consultation document addresses nearly all of the issues that are relevant to this review. There are only a few omissions, the most important of which is the lack of any discussion about the potential stranding costs the DNOs would face if there is a decision to have an accelerated rollout of smart metering. The regulatory logic for allowing cost recovery in such a case is clear and will need to be included in future consultations. We are sure that Ofgem will recognise that this is an omission which will need to be properly rectified as we move through the DPCR5 process.

The other important omission is the lack of any signal that connection charging policy will be reviewed as part of the DPCR5 process. Our forecasts for the DPCR5 period indicate that an increased proportion of costs will not be recoverable by connection charges compared to the DPCR4 period, and this is in part due to the shallowing of connection charge policy introduced for DPCR4.

This is a problem because it increases the cost burden that falls on the generality of customers compared to that falling on those causing the expenditure. It used to be the case that a DNO would only make an allowance for general reinforcement if any surplus capacity (usually due to the standard sizes of plant) would be of foreseeable use – in other words, if there was a need for general (non-attributable) reinforcement anyway. However, the introduction of cost apportionment factors into DNO connection charging methodologies has taken away discretion, with the result that the costs of additional capacity always fall on the DNO, and hence on customers generally.

For example, under the current approach, a customer requiring 10MVA which requires us to install 20MVA of transformer capacity (being the DNO's standard configuration) would, under the cost apportionment rules, pay only 50% of the costs even where the DNO has no prospective need for the surplus capacity. We believe that the costs of additional capacity in such circumstances should be 100% funded by the customer.

We ask that Ofgem take a fresh look at connection charge policy as part of this review so that the generality of customers only incur non-attributable LRE costs.

Of course, increasing the proportion of connections fully funded by connectees will also have the benefit of increasing the amount of connection work which is contestable and hence should encourage the development of competition.

An increasing proportion of RAV funded capex also increases risks on the DNO because it is hard to forecast while being subject to an incentive rate (connection charge funded work has by definition a net zero cost and a zero incentive rate), and also because it is more at risk from unit cost increases (connection charges can more easily follow prices). Ofgem will need to bear these risks in mind when calibrating and applying its Information Quality Incentive and when devising any adjustment mechanisms for relative price effects.

Conclusions

Ofgem has set out a review process which can be a significant improvement on DPCR4, a review that was hampered by data comparability issues and non-robust cost modelling. We look forward to Ofgem's clarification of the detail and to working with Ofgem in joint working groups established to address the key policy challenges.

We hope you find this letter and the more detailed response provided in the appendix useful and constructive. Please do not hesitate to contact me on 07875 112317 if you have any queries.

Yours sincerely

Paul Delamare

DPCR5 Programme Director