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Dear Rachel

Electricity Price Control Review – Initial Consultation Document

Thank you for the opportunity to respond to Ofgem's Initial Consultation for DPCR5. The document raises a number of important issues for ENA's electricity DNO members. I have concentrated my comments on three particular areas, first developments in the overall energy market environment including in the light of the UK's 15% renewable energy target by 2020, which sets the context in which this review is taking place; secondly the roles and responsibilities of electricity distribution businesses within this new environment and thirdly, the framework for the review itself.

Perhaps the first and somewhat obvious point to make is that the DPCR5 review period does not end until 2015, only five years before this Government target has to be met. Consequently, considerable progress towards the target will have to be made during the review period. This has been recognised within the document by including 'the environment' as one of its three key themes. There is therefore much discussion about the need for financial incentives to tackle climate change, the facilitation of greater amounts of Distributed Generation (DG) and the development of active network management. Our concern however is that these discussions risk being conducted in a long term vacuum. It was hoped that the LENS work would produce a range of long term scenarios to ensure that the price control was set firmly within a longer term context. In particular back-casting the scenarios to 2015-2020 would have provided a clearer indication of the scale of the changes necessary to meet the Government targets and no doubt would have provided an important insight into what will be required from the DNOs over the next 10 years or so.

Notwithstanding our concerns with the process for determining the context for the review, I would like to emphasise that the DNOs are very supportive of an expanded role and are ready and willing to take up the challenges presented, including both becoming more involved in customer and demand-side issues and perhaps most importantly, playing a full role in helping to tackle climate change. The radical transformation of the energy system called for by Government calls for a comprehensive review of the role of distribution, and how regulation can support the transition. We therefore welcome your proposal to set up a joint Ofgem/industry policy group to discuss such issues and look forward to participating fully within it.

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If there is one concern with the issues discussed within the consultation document it is the inference that the DNOs are in some way at fault in not having expanded their role already with the result that, for example, the aspirations for increased distributed generation are being frustrated. DNOs have responded appropriately to the established regulatory framework which has given them specific and focussed obligations. They have in no way acted as a barrier to the development of DG. Indeed, such an inference is we believe a misunderstanding of the nature of the DG incentive itself. The current ‘incentive’ is limited because it only applies to costs recovered through GDUoS whereas most DG connections require sole-user assets which are of course recovered through the connection charge. Indeed the current incentive is more of an (albeit imperfect) DNO cost recovery mechanism than an incentive designed to attract greater amounts of DG to connect to DNO networks.

Moreover, DNOs have undertaken much work to make the connection process easier and more transparent. For example, tools are currently under development that will enable a prospective generator to access a DNO’s digitised network records and undertake an initial network connection assessment of possible generation projects, and hence identify the most attractive options. This activity complements a number of other reports and studies, supported by the BERR / Ofgem sponsored Electricity Networks Strategy Group’s Distribution Working Group (DWG) and its predecessors written to facilitate the wider penetration of distributed generation, including for example: the ‘Solutions for the Connection and Operation of Distributed Generation’ (2003); the ‘Technical Guide to the Connexion of Generation to the Distribution Network’ (2004); and more recently, the ‘Future Network Architectures’ report (2007)[1].

Work is also in progress to review the requirements under ER G59 (and ETR 113) and ER G75 that should ease the requirements on generators in terms of interface protection (for example requiring only one-off type testing in certain circumstances).

Indeed from the evidence that we have, the lack of take-up of DG is not attributable to the connection regime employed by the DNOs but rather it is the result of issues outside the control of the DNOs, i.e. the planning regime and the problems of transmission access.

Similarly the limited take-up of the RPZ scheme is perhaps the result of the design of the scheme rather than the lack of support from the DNO community. Several of the RPZ technologies, once proven, will be transferable to other networks and integrated with other technologies to develop further some `smart grids’ type of network. We look forward to discussing how the scheme may be extended to provide greater opportunities for flexibility and repeatability whilst including further innovative ways of designing and operating the network on an ongoing basis

As we pointed out in our response to your May 2007 Open Letter, the DNOs have, since privatisation, achieved significant improvements in operating efficiency whilst providing support to the competitive energy retail market. This period has also been characterised by a reduction in the scope of electricity distribution business activities, inspired by Ofgem’s policies on business separation and the supplier hub. The result has been leaner, fitter businesses but businesses that operate within clearly set boundaries and with deliberately reduced customer related responsibilities. Changing this situation to enable DNOs to participate fully in tackling climate change may need more than the addition of new incentives to the current regulatory framework. It may

[1] http://www.ensg.gov.uk/

also need a look at the DNOs' duties and we would welcome further discussion around this important area.

If such changes to the roles and responsibilities of DNOs are to be considered the resulting risk / reward balance for the companies will be key to their success. It will also be important to clarify the respective rights and responsibilities of suppliers and distributors as the markets become more sophisticated. There should be scope to achieve a fair return to provide the necessary finance to fund these activities and the incentive to perform them efficiently. The current price control rewards the installation of assets and the minimisation of risk. Achieving a more radical vision will require a greater emphasis upon service delivery and a recognition that innovative solutions may require fewer assets but place greater risk on distributors. This should not be taken as reluctance on the part of the companies to expand their role in the energy market. On the contrary they are looking forward to the challenge, but such issues will have to be resolved if the necessary progress is to be made on implementing any new arrangements.

Whilst many of the issues discussed above will give rise to changes in the regulatory framework for DNOs we strongly support Ofgem's view that incentive regulation should be the basis for achieving the desired outcomes. Some concern has been expressed by Ofgem about the complexity of the incentive regime and it has been suggested that as part of the Better Regulation agenda it should be simplified. We do not agree with this view. Whilst we support the principles of better regulation, it should not necessarily imply simple regulation – ours is a complex industry that sometimes requires complex solutions. The incentive mechanisms currently in place are well understood within the industry and experience shows that they work well to modify behaviour. Any increase in the numbers of well-designed incentives arising from an increase in DNOs' responsibilities should be acceptable provided that they are consistent with the overall incentive regime and not applied in a piecemeal fashion.

The consultation paper is very comprehensive and addresses the important issues for the review in a detailed and well-considered way. Our response will not comment upon every question that is posed by the document but concentrates on the key issues for ENA members.

(i) Environmental Issues
DNOs are keen to engage with Ofgem to examine ways in which they can contribute to tackling climate change both by lessening their own impact on the environment and by responding positively to the changing needs of customers and other market players. Two of the key issues which we would like to raise in this regard are the current DG and losses incentives.

We have already commented about the current DG incentive above in the context of the roles and responsibilities of the DNOs. Another of its drawbacks is the separation of DG use of system charge revenues from the main price control. Consequently, there is no interaction between the two, with the flow of funds between the two revenue 'pots' restricted to very limited circumstances. A move to a single revenue 'pot' would be welcomed, along with a review of the DG incentive scheme to ensure that DNOs are best placed to facilitate the connection of DG onto their networks.

We recognise the important environmental contribution that DNOs can make by reducing technical losses where practicable. We also recognise the need to revisit the current losses incentive mechanism and to seek one that will reward cost-effective approaches to their reduction. The current incentive is not strong enough to drive significant investment to reduce technical losses. This is partly due to major measurement problems associated with the calculation of network losses.

In order to create a clearer link to environmental objectives, we suggest that an incentive that matches rewards and outputs could be devised that recognises that not all outputs may be directly measurable, especially in the short term. Such a quasi-output mechanism could evaluate the potential for loss reduction and be based upon the calculated loss/carbon reduction of particular types of investment. This could then be used to remunerate the DNOs, based perhaps on an agreed forward price of carbon.

It may also be worthwhile to consider any such initiatives within an overall carbon measurement mechanism such that the engineering possibilities for reducing losses can be assessed against other carbon reduction options. Consideration also needs to be given to the net carbon impact of such initiatives, i.e. loss reduction may not necessarily lead to carbon reduction if the mitigating measures are themselves high-carbon.

Of course, it will also be important for the efficient operation of the market (rather than for environmental reasons) to retain incentives to reduce commercial losses arising from registration and settlements problems as well as illegal abstraction. Any reduction or removal of the unit revenue driver will represent a significant weakening in this respect.

(ii) Customers
We believe that the DPCR5 process will benefit from the explicit emphasis upon greater stakeholder engagement to inform companies' business plans. Stakeholder involvement will allow DNOs to present locally supported, well informed plans to Ofgem. It may not be straightforward for companies to reconcile the varying and often conflicting priorities of national suppliers and regional stakeholders, and ultimately they will have to exercise judgement in preparing their final submissions; Ofgem in turn can then assess the plans in the light of its own willingness to pay survey.

The current IIS arrangements have helped to improve the quality of supply for the vast majority of customers since its inception to a level where there is broad satisfaction with performance. However it is probably appropriate now for Ofgem to review the scheme; in particular we agree that the time is now right to consider those customers who have not experienced such a good level of service and are currently 'worst served'. Customers who experience the worst service levels are usually in rural areas served by networks with fewer connected customers. Under the existing framework, companies are unable to build an appropriate business case for investment in these areas; consideration should therefore be given to a specific allowance to enable DNOs to consider options for network improvements to these groups.

With regard to competition in connections, we have over the past year seen the introduction of new Licence Conditions to ensure adequate performance by DNOs where they interface with Independent DNOs (IDNOs) and Independent Connection Providers (ICPs). These requirements have only recently been implemented, and are bedding down well, with a number of companies experiencing increasingly positive customer feedback on their performance. We therefore do not believe that any further formal obligations are necessary at this time.

The characteristics of the connections market will mean that there are some areas where competition is unlikely to flourish, such as small scale domestic housing developments, and we agree that these may be best provided by the DNO as a regulated product. However, where there is potential competition, DNOs should be able to bid on a commercial basis, and retain any margin that is available. This will help to stimulate competition as currently the incumbent DNO is required to charge at cost.

It is important that Ofgem's measure of 'success' in a market sector should be more than simply assessing market share. We therefore suggest that it considers both awareness of competition and quality of service to customers, along with market share, when assessing the extent of competition in the various segments of the connections market.

You will be aware of the considerable work that the DNOs have undertaken to support the implementation of the arrangements resulting from the CEAR Act. The voluntary Energy Ombudsman Scheme was put in place in April well ahead of the 1 October statutory requirement and companies have also developed clear, easily understood and effective complaint handling procedures; we are also currently liaising with both TOSL and energywatch to ensure a smooth transition to the new arrangements. We believe that DNOs should be given the opportunity to demonstrate the effectiveness of their procedures before Ofgem considers whether there is a need for a Guaranteed Standard.

(iii) Networks
As the role of networks evolve so must Ofgem's approach to assessing the DNOs' proposals for investment. Not only will there be a significant requirement for replacement and load related investment, but also investment associated with the response both to the low carbon agenda and to climate change itself (flood protection, severe weather resilience etc).

It is important that each DNO is adequately funded to deliver a safe, secure and sustainable network and that the cost drivers facing DNOs are recognised by the cost analysis. We support Ofgem's introduction of the building blocks approach and the greater clarity that it should bring to cost assessment. In doing so, it will be important that Ofgem utilises this approach to understand individual DNO assumptions and plans, and benchmarks the DNO against its own assumptions, recognises the requirement for judgement in forecasting and ensures that definitions are appropriately documented and consistently interpreted. Every effort should be made to avoid `cherry-picking' what might appear to be best practice when using analytical benchmarking comparisons across DNOs.

We also welcome Ofgem's recognition of the significance of real input cost inflation in this area and the future skills challenge faced by all the companies over the next review period and beyond.

(iv) Financial Issues
We believe that there are important principles to be established at DPCR5 to ensure the appropriate financial framework for DNOs. The weighted average cost of capital (WACC) in particular is a key element of this framework and it is vital that an adequate WACC is determined to protect the incentives to invest and maintain investor confidence. Its level needs to reflect the opportunities and incentives inherent for the companies to out-perform their targets as well as the risks inherent in the businesses, particularly at a time of rising investment, and those arising from the regulatory framework itself.

We do not believe that it would be appropriate to make any significant changes to the level of gearing used at DPCR4 and note the CAA in its recent price control determination endorsed the view taken by the Competition Commission that 60% gearing achieves an acceptable balance between efficiency and resilience.

We support the basic framework of the CAPM methodology for setting the cost of capital, when used pragmatically. We note that other models can provide a useful sense check for this familiar approach to determining the cost of capital. Longer term market indicators should be used in the WACC calculation which would implicitly allow for the cost of some historic debt, although some allowance should be made to reflect the risks of shorter term market volatility. With regard to the construction and introduction of debt indexation or trigger mechanisms, this effectively transfers risk to customers which runs counter to the principle of leaving risks with those best placed to manage them. Furthermore, the practical problems around implementing such mechanisms are considerable and we (and indeed Ofwat) do not therefore support the use of such mechanisms. We note that both the CC and CAA have recently come to the same conclusion.

If the WACC is adequate, it should attract equity issuance and there should be no need to consider any specific ‘financeability’ adjustments for particular companies. Other than retaining the current approach to accelerated depreciation in the period through to any more fundamental changes arising from the RPI @ 20 review (and ensuring it is applied consistently across DNOs) specific financeability adjustments are not favoured.

Setting the WACC at the appropriate level should ensure all DNOs are able to meet financeability tests and maintain their ‘investment grade’ credit ratings. In the current financial climate where investors are more averse to risk and are increasingly focussed on the need for strong credit ratings, there is a strong argument for Ofgem to clarify its definition of ‘comfortably within investment grade’ particularly given the anticipated need of DNOs to raise debt to deliver increasing levels of investment. Financeability tests also need to recognise that rating agencies are introducing new ratios and that they assess businesses on a statutory accounting basis, which is becoming increasingly different from the regulatory accounting conventions historically used in Ofgem’s modelling.

Electricity distribution businesses are by nature long term and are currently facing a number of important long term challenges including increasing levels of capital investment, significant technological change and the need to fund R&D and skills development and recruitment of new resources into the industry. It is therefore extremely important that Ofgem makes commitments on investment and its financeability over the longer term to ensure that investor confidence is maintained and the necessary finance for investment is forthcoming.

The Initial Consultation paper also refers to the recent increase in Market to Asset Ratios (MARs) for some utility stocks and the implications for the WACC. We believe that this increase is a short term phenomenon and there are significant factors other than the WACC to explain investors paying premia to RAV. These may include views of out-performance against regulatory allowances, anticipated RAV growth, synergies from the wider group acquired etc. It may also reflect recent market conditions which have seen strong demand from pension and infrastructure funds for assets delivering index linked income streams leading to artificial increases in the price of such assets.

Finally, we look forward to your proposed paper on pensions later in the year. This is a very important area for the DNOs and we would like to re-confirm our view that efficiently incurred pension costs should continue to be allowed using the principles established at DPCR4.

(v) Process and Timetable
We welcome Ofgem's proposed approach to the review process including its transparency, use of impact assessments, longer consultation periods and more involvement of interested parties. ENA members look forward to participating fully in the proposed joint Ofgem / industry working groups and urge Ofgem to establish them as soon as possible. In terms of the timetable published in the paper we have a number of comments:

- It would be helpful to get clarity over the nature of the forecast data requirements during 2009 and how they interact with the IQI base case assessment.
- Although we welcome your recent re-assurance that Ofgem will ensure that there will be every opportunity for dialogue over the period between June and November 2009, we still maintain that a September Update paper is a very valuable element of the review process and would urge you to re-consider its proposed withdrawal.
- We also welcome your proposal to publish draft licence modifications with the initial proposals.
- We would like to obtain greater visibility of Ofgem's detailed work plans through to the issuance of the Final Proposals to help internal resource planning in the companies and to help understand the points to engage with DNOs to shape the appropriate outcome. In particular, we urge Ofgem to make available the financial model far earlier in the process than is currently proposed.
- It will also be important that there are early decisions taken on the outstanding issues from DPCR4.

I hope you find these comments useful. We look forward to participating fully in the review process and hope that together we can make considerable progress over the forthcoming months on the many outstanding policy issues raised in the paper.

Yours sincerely

Andy

Andy Phelps
Director of Policy and Regulation