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Dear Rachel,

Electricity Distribution Price Control Review Initial Consultation

Thank you for giving National Grid the opportunity to provide our views on the Initial Consultation of the Electricity Distribution Price Control Review. We have a number of comments regarding the questions set out in the consultation and these are outlined below.

If you require further clarification of the points raised or wish to discuss matters further, please do not hesitate to contact me.

Yours sincerely, (by email)

Paul Whittaker
UK Director of Regulation
National Grid

Chapter 2 – Environmental Issues

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?

The role of DNOs is likely to evolve considerably over the next few years. Sufficient flexibility will need to remain in the regulatory and commercial framework – even after DPCR5 – to allow this evolution to continue.

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?

We believe the consultation has identified the main activities, over which the DNO has a direct influence that could contribute towards reducing GHG emissions.

Question 3 How do we ensure progress is made on these issues identified with the connection of DG? Should progress be facilitated through a working group or should more formal obligations be developed?

It would be prudent to explore the standardisation of both connection agreements and the connection process. The process of standardisation would lead to the sharing of best practice and would allow a more efficient business process to emerge. This greater clarity would reduce the barriers to entry often associated with the complexity of securing connection agreements.

Any standardisation of the connection process should consider the potential interaction with any obligations that DNO's may have under the CUSC and the associated interaction with the transmission system connection processes. It would be beneficial to make sure that the timelines of these, potentially related, processes are aligned in order to further capitalise on potential gains in efficiency and transparency. To ensure the formal obligations developed are an improvement to the connection process, they should not be inflexible or restrictive in their application.

It is important to look at the causes of lower-than-expected connection of distributed generation. It is our view that this review needs to look at access to market, incentives and the compatibility of wider wholesale and trading arrangements.

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?

The incentives on DNOs need to be calibrated against the costs and societal benefits of possible carbon reductions. In principle, we believe that appropriate incentives on DNOs to reduce their carbon footprints would probably be stronger than they are today, taking proper account of available carbon pricing signals.

Question 5 How can the Long Term Development Statements be made more useful for the DG and other users of the Network?

Any method of improving the investment signals to DG and other network users would be beneficial. Providing improved signals on areas that are preferential or beneficial for losses and / or system investment would aid in the decision making process for new connectees.

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?

Distributed Generation (DG) has an important part to play in the future evolution of the GB electricity industry. The challenging national and European targets for reductions in greenhouse gas emissions will require the development of a wide range of generation, and demand reduction, options including expansion of DG capacity. As such, it is important to ensure that the developments of markets, incentives and licensing arrangements are aligned to help and not hinder the development of DG.

We agree that it may be prudent to look to revise the current regulatory framework in order to increase the ability of the DNO to meet renewable capacity requirements. It is important that when looking at such revisions the assessment considers the consequential impact and, if necessary, manages the implications or changes required for other segments of the market.

The earlier connection of renewable capacity through active generation, rather than the reinforcement of the network, is one example where the implications for the wider market must be considered. This is a substantial change to the current process and could involve the DNO effectively changing the output of distributed generators to resolve constraints on the distribution system. Depending on the mechanism by which this is accomplished, this could have an impact on the operation of the transmission system and on the electricity imbalance price as well as the energy account position of BSC parties. As such, it is important that such change considers the implication in these areas.

The incentive for parties to invest in distributed generation will be in part dependent on their possible routes to market and the different market segments in which they can compete. Reactive power provides a prime example of where distributed generation could, with a review of the current obligations for its provision, establish itself as a valid competitive service provider. If the parties responsible for the use of reactive power could be identified it is possible that they could be made responsible for its provision. This could be accomplished either through their direct procurement from appropriate sources, or through a charge for the reactive power that are caused to be centrally procured. Such changes may increase the economic attraction of embedded generation investment by providing operators with an avenue to compete in this market.

At present, there are a number of GSPs that export from Distribution Networks onto the transmission system and, given the forecast projected growth in embedded generation in future years, this is expected to occur on a more frequent basis. In addition, active networks may change the demand dynamic for each GSP, interacting with the SOs ability to operate the system.

The increase in bidirectional volatility across these boundaries will have an impact on the ability of the System Operator to carry out its system balancing activity. The current transmission access arrangements do not provide a defined access product for GSPs which export to the transmission system. National Grid is therefore currently considering the potential implications of this and may consider developing a transmission access product for exporting GSPs. Given that there is significant potential for a GSP to export on a net basis as the result of one or more distributed generation projects, the obligation for exporting GSPs and the potential access product may therefore be the responsibility of the DNO.

The introduction of a defined product would bring consequential obligations to manage the flow across the GSP boundary. It is unclear which party would be best placed to manage these flows. However the balance responsible party would need to have the ability to manage distributed generation in real time. As such if this party was the DNO a mechanism to instruct, and potentially compensate, generation to alter their load level would need to be developed. The implications for energy account position and imbalance price arrangements would also need to be understood.

Question 7 We have raised more detailed questions throughout the chapter. We welcome views on these issues.

No comment.

Section 3 – Customers

Question 1 Do the current regulatory arrangements deliver the levels of service that customers expect?

No comment.

Question 2 Is the focus and scope of the current regulatory arrangements correct and are there any gaps that need to be addressed?

No comment.

Question 3 Are DNOs customer focused enough or should they be doing more to improve communication with customers?

No comment.

Question 4 Is DNOs' financial exposure set at the right level and/or do we need to change the emphasis in certain areas?

No comment.

Question 5 Do you think we have identified the right issues and appropriate areas for development within the existing incentives?

A key customer issue for the DPCR5 will be the quality of service that customers receive with regards to connections and the role that DNOs should play in improving this service. National Grid has restricted its comments to this specific issue.

Ofgem highlights that it introduced several measures, including a new licence condition and voluntary standards for DNOs last year as a result of the connections review, but it still has a number of issues relating to electricity connections performance:

- “most complaints to Ofgem concern either the costs involved with or the quality of service received when seeking a connection”
- “concerns about the pace at which competition is developing”
- “emerging competitive market needs support”
- “concerns regarding anti-competitive behaviour”

National Grid Gas has similar duties to the DNOs and we have worked hard to improve gas connections performance. New and revised standards of service for gas transporters were introduced on 1 May 2005 and payments are made to customers if we fail to meet the specified service levels. We actively promote the importance of meeting customer commitments in respect of guaranteed standards in connections activities and have ensured that standards of service processes are consistent and robust.

We are also active in facilitating competition in the gas connections market and over 70% of new domestic connections are now provided by Independent Gas Transporters (IGTs), with Independent Connection Providers (ICPs) performing nearly half of all these gas connections.

The initial consultation document indicates that there may be elements of gas connections that could be adopted in electricity. Given the improvements in the quality of service and the levels of

competition in our network geography, we understand why it may seem for “consistency” a worthwhile approach to adopt. However, before changes are made to the current connections framework in electricity, it is important to understand how successful the connection review initiatives have been in improving performance and to quantify the above mentioned concerns.

Our initial views on Ofgem’s proposals are set out below.

Introduction of financial incentives to respond to requests for connections within a timeframe

In setting any financial incentives with regards to quotation request timescales, Ofgem should be mindful of the impact on competition. For example:

- Timescales for the DNO to respond to customers should not be beyond those that the competition can deliver. If the DNO has to respond to the customer in 6 working days and the competition are only resourced to do so within 10 days, then the customer may choose to use the monopoly provider and in some cases this may be regardless of the cost.
- Where a connection request requires the competitive provider to request information from the DNO first, then the DNO should provide this information in a timely manner, so that the customer can receive a competitive quotation in-line with that provided by the DNO.

Extend licence conditions (provision of quotations and completion of connection works)

We believe that where effective competition exists or is developing successfully, regulatory obligations should be removed or minimised. Where effective competition is not practical and the prospect of the removal of barriers to competition is limited, then appropriate obligations and incentives should be used to protect customers and facilitate a good customer experience.

Customer protection can be provided by a range of options, including licence conditions, voluntary standards and guaranteed standards of service. We do not believe that this means that all of the options should be utilised to deliver improvements in the quality of service. For instance, we have argued consistently that it is inappropriate to maintain standards of service that measure connections performance (Standard Special Condition D10) at the same time as paying compensation on exactly the same standards under the Gas (Standards of Performance) Regulations. Customers are adequately protected through compensation payments and do not require additional measures under Standard Special Condition D10.

Introduce standard pricing mechanisms to regulate connection charges for domestic customers (and other customers where effective competition is unlikely to develop)

Assuming that standard pricing mechanisms is a reference to standard charges as used by GDNs for domestic consumers, there are a number of arguments for and against their use. Arguably, a customer should pay the actual cost of providing the connection, as this most accurately reflects the employment of the service provider. However, in gas distribution we have utilised standard charging for certain services, with the aim of achieving an economic and efficient balance between accuracy of charging and a general cost-benefit to relevant customers from not having to resource large-scale survey, design and quotation activities for frequently requested jobs which are similar in nature. In addition, where standard charges can be applied to fully contestable services, this helps facilitate competition by making charges openly accessible to prospective customers.

Structural separation of DNOs’ connection businesses (separation of contestable and non contestable activities into separate ring-fenced businesses)

The economics of conducting structural separation of connection businesses may be questionable and outweigh the size of any issues relating to instances of anti competitive behaviour. As mentioned earlier before changes are made to the current framework, it is important to quantify any concerns.

Treatment of costs and customer contributions (added to RAV) - looking to allow a margin on contestable/competitive connection activities by excluding them from the PCR.

We support DNOs being able to earn a reasonable margin on contestable/competitive connection activities, as to do otherwise, could mean the DNO charging less than competitors who must generate a profit margin. This approach was recently taken in the Gas Distribution Price Control Review and reflected in Standard Condition 4B of the gas transporter licence.

Accuracy Challenge Scheme

One further area that has not been specifically discussed in the initial consultation is how to improve the accuracy of connection quotations. Our connections Standards of Service require us to have a published accuracy scheme that allows customers to challenge a quotation and if it is found to be inaccurate (within defined limits), the Gas Transporter shall refund any overcharge that has been made. This scheme provides the customer with some re-assurance on the quality of the quotation they have received and it may be useful to explore if such a scheme would be beneficial for electricity customers.

Question 6 We have raised some detailed questions throughout this chapter. We welcome views on these issues.

No comment.

Chapter 4 – Networks

Question 1 Have we captured all the key lessons learnt from DPCR4 regarding cost assessment?

We are unable to comment directly on whether Ofgem has captured all the key lessons learned from DPCR4. However, the issues listed in paragraph 4.23 are lessons that can be seen from the recent GDPCR review. In that review, the introduction of new revenue drivers and the Information Quality Incentive (IQI) are seen as improvements in the regulatory model. The use of the annual reporting pack should help drive better understanding of costs and the drivers of those costs. We also support the intention to remove distortions and to increase the capacity for price controls to reflect the specific business needs, strategies and objectives of each network.

We would add that there are other lessons learned from GDPCR that should be continued including a top-down adjustment to take account of the “cherry picking” effect inherent in picking the “best of the best” from bottom-up analysis and the assumptions on productivity from upper quartile (efficient) position. These are discussed further in answer to the other questions.

Question 2 Is our approach to cost assessment appropriate? and

Question 3 Are there alternative approaches to cost assessment that we should be considering?

We believe the approach to cost assessment outlined in figure 4.3 of the consultation document is, at a high level, appropriate. There are however a number of issues that Ofgem need to consider in the detail.

We support the use of a variety of tools to determine an outcome that strikes the right balance between allowances and obligations. Potential issues that will need to be considered along the way include:

- Application of benchmarking – see answer to question 4
- Bottom Up analysis – During GDPCR a top down uplift was applied to the results of the bottom-up analysis to remove the “cherry picking” effect of setting allowances on the “best of the best” - to not do so would be to ignore the inherent different operating characteristics of each network. A further high level adjustment was applied to seek to address the impact of differing investment strategies (capex/opex trade-offs) similar to DPCR4. Development of this approach as outlined in the consultation may be appropriate.
- Expert review of DNO forecasts – Input is required not only in reviewing individual investment requirements, but also in considering the potential for frontier shift. In this respect, consideration should be given to the following:
 - Ongoing productivity - clear evidence to support the assumptions for productivity improvements from an efficient (upper quartile) network is required. Limited evidence was made available during GDPCR.
 - Cost to achieve – If Ofgem assumes that further efficiency improvements from the efficient benchmark are achievable then it is only fair that an appropriate allowance for costs to achieve is given, otherwise shareholders are required to fund such costs but with 100% of the benefits given to customers. This can be a deterrent to networks seeking further cost reductions.
- Development of IQI – covered further in answer to question 9

With regard to outputs, during GDPCR National Grid supported the development of new incentives (to support issues of meeting evolving customer requirements, e.g. carbon costing in leakage incentive), revenue drivers (to support an unknown level of loss of meterwork) and specific re-openers (e.g. for the Traffic Management Act).

We would, however, stress the need to consider these items early in the process so that full understanding of the impacts can be assessed. For example, the specific mechanics of the revenue driver for loss of meter work were only made known in the Final Proposals and did not address the impact of loss of meter work on overhead costs.

Question 4 How might our approach to benchmarking be improved?

We believe that further improvements can be made to Ofgem's benchmarking approach through consideration of the following:

1. Adjustment for regional differences - During GDPCR Ofgem only adjusted its regression analysis for labour costs for higher pay rates for direct and contract labour in London relative to other parts of the country. Any variation between a company's specific performance and the trend line (be it average, upper quartile or frontier) was assumed to be solely due to efficiency. This assumption, especially applied to activity costs where the level of fit is weak (below 0.9) and on such a small sample size, will inherently penalise networks. We believe this to be overly simplistic and either a catch-up allowance or partial closure of gap should be applied, although we recognise that "explanations" of specific GDN differences should be evidenced.
2. Choice of drivers – The degree of fit of the drivers for some activities within GDPCR was not always the most appropriate. Consideration of drivers should be done upfront.
3. We note that Ofgem has engaged an economic consultant to advise on the application of benchmarking techniques and on the use of international comparators. Great care needs to be taken here.

During DPCR4 Ofgem recognised the difficulties in comparing historical DNO performance caused, primarily, by inconsistencies in reporting of information between companies. As a consequence, a licence obligation was introduced for annual regulatory reporting of cost and asset information to improve consistency at an appropriate level of detail to allow for comparative efficiency analysis.

Similar difficulties arose during GDPCR and, again, Ofgem has introduced a licence obligation of GDNs for annual regulatory reporting.

It is clear, therefore, that it is difficult to undertake reliable comparative efficiency analysis within an industry without a rigorous data gathering process. To attempt to introduce international comparisons without an equivalent data gathering process is almost certain to result in inappropriate conclusions being drawn.

Question 5 Have we captured all the key issues for "networks"?

We believe the challenges outlined in paragraphs 4.9 to 4.21 appear to capture the key issues for DNOs for the next price control period.

Question 6 Is our building block approach to forecasting appropriate?

The approach to use building blocks would appear to be appropriate method of developing cost assessments.

Question 7 What is the scope for developing additional output measures and how can these be incorporated into the price control?

We agree that in setting price controls, it is important that the regulator, customers and companies understand what levels of output are required. As Ofgem suggests in paragraphs 4.54 and 4.55, the current range of customer focused output measures and associated financial incentives provide strong incentives to deliver improved performance to customers.

Whilst further enhancement may be possible, it needs to be recognised that any incentive scheme should not penalise a particular network for what may appear to be poor performance, relative to that achieved by others, that is in reality driven by factors that are largely outside its control e.g. the specific issues associated with London – high rise buildings, parking and highways working constraints, etc.

We agree that demonstrating consumer benefit from network investment is also important. However, we believe it will be difficult to adequately take account of the following issues associated with using asset health indices within an incentive regime:

1. There are a large number of asset types in use and each asset type will have a range of potential health indicators. For example, a particular type of asset may have poor environmental performance, whilst being reliable and safe. It is not clear how an incentive process could meaningfully be applied without either significant complexity, which would have its own problems, or concentrating on a limited number of indices to the detriment of others, or diluting signals by bundling individual measures, which would mask specific problems.
2. DNOs are likely to have different asset type mixes built up over several generations. This means that decisions taken many years ago could be distorting current asset health performance relative to that achieved in other DNOs. A fair incentive regime should take account of current management performance; there is a risk that any proposed incentive scheme could simply reward or penalise past decisions, given the very slow rate of asset churn.
3. Consistency of asset health indices across DNOs, given the different asset information systems in use.

Network operators have demonstrated considerable expertise in owning and operating safe, reliable and efficient major distribution energy networks within the UK. This has been achieved against the background of high level, but effective, licence requirements such as the 1 in 20 supply security standard applied in the gas industry. We believe that the adoption of PAS55 would be an effective step that would build on this record. It provides a good basis for long term asset management and ensures that both investment and maintenance are optimised to achieve organisational objectives (e.g. safety, security of supply). Furthermore we believe the 5-yearly price control review, including specialist consultants reviews, already provides a good opportunity for Ofgem to assure itself that networks are being effectively managed to ensure long term sustainability.

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?

The proposal to gain more stakeholder input into business plans is seen as a desirable aspiration and one that may enable the businesses to meet different requirements. However, a potential issue is that

in reality the requirements of different stakeholder groupings will be similar across the UK and, therefore, it may be inefficient for each company individually to seek input from the same stakeholders.

Question 9 Is the IQI and capex rolling incentive the best way to ensure realistic forecasts and efficient investment?

We believe that a combination of IQI and the capex rolling incentive provides companies with improved incentives to submit realistic capex forecasts and manage their overall risk and reward profile.

We note that actual DNO capex during the first two years of the current price control has been lower than the allowances established during DPCR4. This would appear to be driven by difficulties in mobilising resources during a period of high demand for contractors and that DNOs expect their capex to ramp up over the remaining three years of this period.

We do not necessarily agree that the underspend to date suggests that DNOs may still have an incentive to over-forecast (the IQI model benefits a company that spends what it forecasts, so they have considered risks when developing their forecast) and/or beat capex allowances rather than making efficient investments. A greater understanding of the drivers of DNO capex is required although two years experience is probably too short a period to draw such a conclusion.

Question 10 How might the IQI and capex rolling incentive be improved or what additional measures could supplement them?

The introduction of the Information Quality Incentive at DPCR4 and its subsequent adoption in GDPCR has given companies an element of choice regarding investment incentives. For example, in terms of the absolute level of investment allowances and the balance of sharing of any over/underspend (the power of the incentive).

A period of stability is now required to assess whether the mechanism is working appropriately before making further changes.

However, consideration should be given to whether such an approach could be used for operating expenditure which would also help address the issue of distortions outlined in paragraph 4.27.

Question 11 Should we aim to equalise incentives on network investment and business costs and how could this be achieved?

The current difference in the power of incentives could lead to distortions between opex and capex costs, but also has the impact of placing far heavier risk/reward on opex.

The setting of a frontier shift that cannot be met by DNOs, in part by input prices outside their control, did not provide any balance between Ofgem and network views. Giving networks an element of choice in the level of allowance and the power of the incentive, as with investment, may also be appropriate for opex.

Question 12 Is the timetable realistic?

The timetable does appear to be realistic.

Chapter 5 – Financial Issues

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?**

Question 2 **and**
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?

Ofgem’s traditional approach has been to use the long-run trailing averages to set the cost of capital but has sense-checked these against a range of other methodologies to ensure that an appropriate forward-looking cost of capital is allowed. We believe Ofgem should continue with this approach which should only be amended if there is clear evidence that the existing approach is no longer appropriate.

Question 3 **Should Ofgem make financeability adjustments or is this a matter for DNOs once the cost of capital is set?**

Ofgem has a responsibility to ensure that DNOs have sufficient funds to finance their activities; financeability adjustments should be considered by Ofgem in this context.

Question 4 **Is it appropriate for Ofgem to be making commitments on investment and its financeability over the longer term?**

To the extent that a sizeable network investment project needs to be made over a period of more than one price control, it would be helpful if Ofgem could provide a level of commitment to fund that investment over the investment period.

Question 5 **Should a mechanism for ex-post adjustments for major changes in the tax regime be introduced and, if so, how?**

Where there has been a material change in the tax regime which affects a network’s ability to finance its operations, it would be appropriate to make ex-post adjustments to reflect such a change.

Question 6 **Do respondents support the publication of a fully populated financial model?**

The development of a fully populated financial model that is shared with the DNOs is essential in ensuring that there is full understanding of price control calculations and, in particular, the derivation of allowed income.

We also support the publication of the financial model, subject to the removal of data which is regarded as confidential.

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?**

We would recommend an approach that strikes a balance between ensuring the profiling maintains credit ratios at the levels required by the rating agencies and limits any sharp increases in price rises

for consumers. Consideration should also be given to the likely size of the P_0 change at the start of the next price control period utilising the investment forecasts provided by the DNOs.

Question 8 What factors should we take into account when determining the level of gearing to assume?

An appropriate level for notional gearing should take into consideration the volatility of the cash flows of the business (including possible cost/income shocks) and any requirement to stay within a particular credit rating.

Question 9 Do respondents agree with the proposed treatment of net debt and gearing in ex-post adjustments to tax allowances?

We agree that such an approach is appropriate.

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?

We look forward to commenting on Ofgem's proposals in this area.

Chapter 6 – Process and Timeline

Question 1 Do you agree with the range of consultation approaches we intend to use throughout DPCR5?

At this stage, the range of consultation approaches look appropriate.

Question 2 Do you believe that we should utilise a consumer orientated challenge group to inform DPCR5?

We believe this would be a useful development.

Question 4 Are there any other ways in which we should look to consult with interested parties?

No comment.

Question 5 Do you agree with our approach to publish specific impact assessments for key "important" decisions?

We do believe this is a useful approach.

Question 6 Are there any other key milestones that you believe we should consider for DPCR5?

No comment.