

Your ref August 2002 51/02

Our ref DRA/KMcH/DPCR

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17 September 2002

Dear Cemil

Developing Network Monopoly Price Controls – Initial Consultation

Thank you for the opportunity to comment on Ofgem's initial Consultation on developing network monopoly price controls. I am providing this response on behalf of Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

We welcome the opportunity to discuss issues surrounding the next distribution price control review (DPCR4) and support the development of a generic approach for undertaking price control reviews. This will help to ensure that price control reviews are carried out in a consistent way for all network companies and increase the level of transparency in the regulatory process. The principal steps that Ofgem expect to follow are undoubtedly the right way forward. We support the proposed process set out in Chapter 2 and we look forward to actively participating in helping to ensure that the objectives are achieved.

The consultation paper also lays a good foundation for DPCR4 itself by setting out initial thinking on the high level objectives. This builds on the work undertaken earlier this year by Ofgem and companies and we feel that early consideration of the DNO outputs will aid the development and confirmation of these objectives.

Our response focuses on Ofgem's initial thinking on objectives and principles for the review and on some key issues. We welcome the opportunity to meet with you during this phase of the project to discuss our thoughts.

OBJECTIVES FOR THE PRICE CONTROL REVIEW

As set out in our recently submitted comments on Ofgem's Three Year Strategy we see the key challenges relating to our part of the industry in the short to medium term as essentially threefold:

- The challenge of meeting relevant objectives and targets with regard to energy policy – particularly in the areas of sustainable investment, security of supply and renewable generation;
- The challenge of providing flexible incentives to facilitate the technological development of distribution networks, if necessary, to move away from passive operation to

accommodate the diverse power flows that would result from the expected expansion of embedded generation; and

- The regulatory challenge of facilitating the meeting of these challenges whilst maintaining a proper balance of interests in relation to all relevant stakeholders.

Previous distribution price control reviews were primarily concerned with capturing the benefits of cost reductions achieved by the companies and passing these onto customers in the form of lower prices. As a result, the cumulative effect of the three price control reviews implemented since privatisation have significantly reduced the allowed income of all companies. It is recognised that this pattern cannot continue indefinitely.

Recent concerns regarding security of supply and network resilience raised by parties such as the Joint Energy Security of Supply Working Group (JESS), Performance Innovation Unit (PIU), Trade and Industry Select Committee (TISC), National Audit Office (NAO) in the public forum need to be taken into account in the development of the next price control.

The above factors now point to a need to shift focus away from short-term reductions in prices and towards the long-term sustainability of our energy networks, in terms of:

- security of supply;
- the level of, and incentives for, efficient investment in networks; and
- the potential re-shaping of the way in which distribution networks are operated.

We believe that maintaining an appropriate level of security of supply requires effective asset risk management techniques supported by an appropriate inspection and maintenance regime, which collects and analyses data to focus capital investment in the network efficiently.

The price control review will transfer the benefits of efficiency improvements to customers. This will be partly achieved through price reductions but it should also be achieved through:

- delivery of quality of supply performance that meets the expectations of customers,
- incentivised investment in the distribution networks to reduce the likelihood of system failure and to maintain the safety of the networks, and
- changing the role of the distribution networks so that it is easier for environmentally friendly forms of generation to become connected.

We therefore support Ofgem's initial thoughts on high level objectives for DPCR4, namely to:

- provide appropriate incentives to DNOs to manage and operate their networks in an economic, efficient and co-ordinated manner;
- provide clear and consistent incentives to DNOs to help ensure they provide an appropriate quality of service to consumers – including incentives for timely and efficient investment in the network;
- seek to ensure that the DNOs can finance their licensed activities commensurate with an efficient level of expenditure;
- provide fair and transparent arrangements for distributed generation;
- provide appropriate incentives to help to ensure that longer term security of supply is maintained;

- reflect Ofgem's responsibilities in regard to energy efficiency, the environment and social issues; and ensure that competition is promoted in the provision of supply connection and metering services;

together with the process objectives to

- resolve key policy issues at an early stage so that regulated companies have more certainty about the price control; and
- ensure that the consultation process is open and transparent and that all interested parties have an opportunity to contribute to the review process.

As the consultation document identifies, the level and nature of investment that will be required in relation to the connection and operation of distributed generation is a key area of uncertainty for DPCR4. It will be important for Government, Ofgem and DNOs to work supportively to ensure that where possible distributed generation issues can be assessed and potential solutions discussed early in the process (even if this is on a scenario basis).

PRICE CONTROL PRINCIPLES

It is important that there is an early understanding for DPCR4 of:

- the required outputs, i.e. what stakeholders expect distributors to deliver; and
- the price control principles i.e. the way in which key features of the control such as operating and capital costs, quality of supply and financial issues will be assessed.

We welcome Ofgem's proposals to publish a principles document in March 2003. The price control framework should also provide consistency in price control principles where possible over a longer time horizon. This would reduce regulatory uncertainty facing companies.

KEY ISSUES

Form of the Control / Incentives

The incentive properties of the RPI-X form of control are well-recognised and well-documented in economic literature. We agree that this underlying form of control should be adopted again at the next price control review because its incentives properties are proven, but modifications are required to enhance its incentive performance and sensitivity to deal with uncertainty and to address increased emphasis towards specific outputs.

We accept that risk should be appropriately allocated between companies and customers. An issue for this control, therefore, is to strike an appropriate balance between the components of the price control to ensure that companies have income put at risk in areas that they are well-placed to manage. Where companies are able to adopt and manage risks then the additional incentive mechanisms should offer a level of return commensurate with that risk. We welcome the opportunity to explore these additional mechanisms but we do believe that most activities would probably continue to be remunerated through the base element of the RPI-X control with the additional elements used to sharpen incentives where required and remove uncertainty where necessary.

Our views on incentives are incorporated in our comments on key issues below.

Assessing Efficiency

We agree that in assessing efficiency full use should be made of available techniques and information. The fundamental basis of efficiency assessment should be the analysis of

company specific information, with benchmarking techniques and market data analysis used as supporting informative tools. Increased focus should be given to the analysis of company specific information by understanding in detail how it has been derived and by looking at the assumptions made. This would address concerns regarding the robustness and appropriate use of normalisation and benchmarking techniques in the process to determine revenue.

In determining the principles to be adopted for assessment of allowed revenues consideration should be given to the treatment of merged companies in the way price controls are reviewed and implemented.

Further development of the methods for assessing efficiency is required to ensure that the balance of incentives between operating and capital costs is appropriately addressed. Total cost analysis is one means of achieving this. The accounting trade off is more significant than the operational trade off and normalisation of data is of vital importance. We believe that significant focus is still required to the regulatory accounting guidelines to ensure that the aims are achieved in relation to transparency, consistency of information between companies and usefulness of information for price control purposes. This would aid in the process of ensuring consistent treatment towards the allocation of expenditure to capital or operational drivers.

Ongoing incentives for operating efficiency would be improved by the introduction of a mechanism that allows companies to retain the benefits of efficiencies for a fixed period irrespective of the timing of the saving. We support the consideration of a rolling operating cost incentive, as introduced by Ofwat and Ofreg, in addition to the existing incentive for efficiency in capital costs. In addition, we think that consideration should be given to extending the period over which such incentives operate. Together, these mechanisms would address the periodicity issues that many commentators have referred to.

Efficiency assessments should also take appropriate account of the outputs that a company delivers. These include quality of supply, asset integrity and system security, and its other statutory and licence obligations, including safety and environmental requirements.

Investment

We believe the framework should retain the incentives for companies to deliver the required performance at the most efficient operating and capital costs and allow them to retain efficiency benefits without clawback. Companies benefit from increased returns and customers benefit from delivery of the agreed outputs and the lower future prices delivered by the reduced RAB.

However, most efficient does not necessarily mean lowest cost and lowest cost is not necessarily something to emulate. We have therefore welcomed the recent initiatives on Asset Risk Management (ARM) and network resilience. The ARM survey could be used to give confidence that companies have attained the required outputs in a robust manner. The Medium Term Performance (MTP) reporting of IIP should be developed alongside ARM to give further assurance that companies are dealing with long-term network stewardship issues.

When analysing non-operating capital expenditure and certain operating costs associated with investment decision support tools consideration needs to be given to equitably recognising such costs. Not to do so could make efficient companies appear to have

relatively high overheads due to these decision support tools used to achieve efficient and effective capital investment.

Outputs

The development of the IIP has sought to balance the incentive to reduce costs with an incentive to maintain or enhance quality. We believe that the current IIP scheme, based on the principle of absolute not relative performance, is pitched at the right level in terms of the amount at risk. It encourages appropriate short-term operational behaviour around the required performance glidepath, without adding dead weight risk to the cost of capital or placing unduly large sums at the mercy of external factors such as weather or the behaviour of others.

After more than a decade of tight incentive regulation it is inconceivable that falling prices and increasing quality can continue to co-exist indefinitely. The balance placed between performance and price by society needs to be understood. It may be more appropriate to focus on particular customer groups (e.g. worst served customers) or the risk exposure of customers to widespread interruption than average customer performance figures.

Dealing with Uncertainty

We welcome Ofgem's recognition that, in deciding how to deal with uncertainty, it is important to consider the most appropriate allocation of risk between companies and consumers. This allocation of risk should be related to the extent of control the company has along with the level of uncertainty and impact of the risk.

In areas of low uncertainty and low risk, a company could be expected to adequately manage within the basic allowance. Whereas in areas of greater uncertainty and risk, a company who is best placed to manage a particular risk should be provided with mechanisms and incentives to do so (which should include appropriate returns). These should allow companies to respond to changing circumstances. Where risk is outside a company's control then other mechanisms such as cost pass through may be appropriate. Areas for consideration for DPCR4 include changes to legislation, investment requirements and operating cost impacts of distributed generation, revenue drivers, excluded services, uncertainty in the regulatory process and the interaction of these factors.

For example, the original rationale for excluding certain services from the scope of the control was linked to the fact that the revenue allowance component of the formula was 100 per cent unit driven. However, the price control formula has and is likely to become more sophisticated and this mechanism may no longer appropriately allocate risk between customers and companies.

Distributed Generation

We agree with Ofgem, that distributed generation is a key issue for distributors, and we welcome Ofgem's initiatives in this area, specifically the recent joint workshop organised with the IEE. We support the view expressed by Ofgem that the next few years, particularly those covered by the next price control period, are likely to see significant developments in the role of distributors, particularly with respect to the successful introduction and exploitation of distribution generation.

We are in accordance with the view, generally expressed at that recent meeting that the key issues are not primarily related to the technical challenge of providing generator connections. Rather they are

- to properly define the role and behaviours required of the DNOs in this vital aspect of energy policy development
- the subsequent development of the appropriate regulatory instruments, including incentives and proper measures, to reward success and penalise poor performance

We believe that it is unrealistic to expect the DNOs to be the principal drivers of the required increase in distributed generation. Rather, we must look to the economic instruments introduced by the government to stimulate 'green' distributed generation, such as the Renewable Obligation Certificates (ROCs). These measures must facilitate developers bringing forward projects. Not all these projects will succeed. However, those that are economic, i.e. where they bear appropriate costs that can be recovered with the aid of ROCs, now face no undue restrictions.

Beyond this, the DNOs are able to make significant, but nevertheless, incremental improvements. Here, the key seems to be to encourage distributors to seek out means yet further to increase the efficiency with which they connect distributed generation. This will arise primarily through better integration of distributed generation connection with other activities on the network. The forthcoming price control review presents an opportunity to embed incentives for good, efficient practice into the core regulatory arrangements. We believe that we should pursue this as a key objective of the review.

As the benefit of most of these efficiencies will flow through to distributed generation developers in the form of lower connection charges (including annualised reinforcement costs), distributors require some explicit incentives. Some options raised at the conference which merit further investigation are revenue drivers related to MW connected and/or MWh accepted onto the system.

We need to review areas ranging from regulatory treatment of relevant investment, impacts on operating costs and quality to revenue drivers, losses incentives and the potential for creating markets for ancillary services.

It is inevitable that distributors will be required to invest more in their networks to support distributed generation. It will be important that the level of investment uncertainty, in terms both of level and recovery, is factored into returns so that the means of funding any additional investment does not produce adverse impacts on existing investors. We have developed our thinking on a suite of potential options to provide appropriate incentives for distributed generation and would welcome the opportunity to discuss these with Ofgem in the near future.

Metering

Two key issues to be resolved prior to the next price control are the treatment of metering assets during the transition to competitive metering services and the removal of potential barriers to the sale of metering businesses.

These could be addressed by Ofgem giving notice that all obligations on DNOs to provide new meters will be lifted in April 2005 price controls would only exist in relation to the existing meter assets. Competition would take place at the point of meter replacement, which would avoid premature replacement and stranding. For existing meter assets the price control treatment would remain unchanged and any new meters provided by the DNO beyond 2005 would be provided voluntarily in the competitive market place and would therefore not be subject to any price control.

Financial Issues

It is vital for the continuing availability of necessary investment that investors should be allowed to earn appropriate returns on efficient investment. An important factor in assessing appropriate returns is the level of regulatory uncertainty and the stability of the regulatory framework over time.

Early indications are of an increase in the cost of capital as evidenced by current difficulties in the equities markets. In a world in which regulation has tightened significantly the presumptions made with regard to the efficient cost of debt could be quite significant with regard to the financial soundness of a company. We therefore look forward to having input into the overall debate in the specific area of gearing and actual debt terms and levels within each DNO.

With respect to depreciation, we assume consistency with the objectives of the approach introduced in the last price control review to address depreciation profiles.

We welcome Ofgem's proposals to increase transparency in future by publishing a copy of each financial model and feel that this area is perhaps one which would merit an Ofgem working group with industry participants.

The price control should protect the interest of present and future consumers. Thinking forward into future reviews beyond DPCR5 the path of prices should be credible in terms of customer acceptance (i.e. not volatile). It will therefore also be appropriate to model the DPCR5 period to inform the long-term path of prices implicit in the DPCR4 price control settlement to ensure that there is long-term stability of prices to customers and ongoing stability of financial ratios and cashflow for companies. In this regard, the issue of funding of capital maintenance on a pay as you go basis would be one that merits further discussion in developing the process.

TIMETABLE AND CONSULTATION PROCESS

There is no doubt that it is important at the outset to set out a clear, logical and achievable timetable for the review and to ensure that this is followed. We therefore welcome Ofgem's statement of intent in this regard. We hope to quickly see more detailed plans developed for the whole of the review process. This will allow all the links with other areas of Ofgem's work to be effectively managed, impacted parties to plan resources appropriately and avoid back end loading of consultation on key issues. To this end, we believe Ofgem should establish the outputs and the objectives of DPCR early in the process. Of particular importance will be

- establishing stakeholders' expectations of distributors; and
- the process and timetable for 2003 including the provision of information from companies through the business plan questionnaire process and a common understanding of the deliverables from the March 2003 and May 2003 consultations and interim milestones to the March 2004 policy document.

It is important for the consultation process to be open and transparent. The key issues to be addressed will drive the information requirements and it is important that companies know why the information is required and have input in determining how it should be collected. Ofgem has demonstrated commitment to openness and transparency through a number of important steps including the establishment of a series of distributor working groups. We welcome these and the 'open door' policy for bilateral discussions with companies.

WAY FORWARD

The work that Ofgem has carried out so far this year, including the consultation paper, represents a good foundation for DPCR4 and for the development of the existing price control framework and regulatory process to the benefit of all stakeholders. The challenge for us all is to keep up this momentum and seize the opportunity that this early start provides.

I hope our comments are helpful to you in taking the review forward. We welcome your offer of bi-lateral meetings and look forward to meeting in the near future to discuss our views in more detail. I shall give you a call later in the week to arrange an appropriate date to start this process.

Yours sincerely

Kirsty McHugh
Director Regulatory Affairs