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22nd August 2003

Dear Cemil

Electricity Distribution Price Control Review - Initial Consultation

This letter, together with the attached document, provides the response of East Midlands Electricity to the Ofgem consultation paper "Electricity Distribution Price Control Review – Initial Consultation" dated July 2003, and the Ofgem consultation paper "Developing Network Monopoly Price Controls – Initial Conclusions" dated June 2003. EME's comments in response to the Metering Price Controls paper and the discussion paper on Registered Power Zones and "Innovation Funding Incentives" also published July 2003, will be made separately.

Firstly, EME appreciates the progress made in the first phase of the price control looking at the network monopoly price control framework, particularly the progress that has been made in joint industry – Ofgem working groups. It is encouraging to see that Ofgem intends to take these groups forward throughout the DNO price review process, particularly the incentives and uncertainty work and the work on quality of supply. The paper lists 3 key issues, which are 'dealing with uncertainty', 'developing the regulatory framework to deal with increased levels of distributed generation', and 'the design of an appropriate overall incentive framework for the DNOs'. EME concurs with the need to address the issues listed.

During this first phase we have also seen welcome clarification and development of Government Energy Policy together with a focus on network security and resilience, social and environmental guidance and fuel poverty. We believe that a key feature of this "Rewiring Britain – A review like no other" will be an enhanced need for investment to maintain network security and accommodate Government Energy Policy objectives. This view is supported by our asset risk management modelling. Furthermore, adequately funded networks are needed to facilitate competition in generation, particularly distributed generation, and to maintain public confidence in the operation of competitive markets. Coincidentally the resources to support that investment are extremely stretched, particularly in terms of craft and engineering resources. At EME, we have already begun to address this issue in our graduate and craft intakes, but the problem is likely to get worse before it gets better. Perceptions of risk have

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been increasing with recent record high temperatures, the October 2002 storms in the UK and power cuts in Europe, the US and Canada. Therefore it is necessary to accurately identify risks, allocate them appropriately and develop new incentives for managing the risks, which will require careful evaluation and appropriate rewards. Finally, against this background, funding including accelerated depreciation, tax and pensions will be important, particularly in an increasingly international market for capital.

The aim of the price control framework should be to incentivise efficient investment, whilst ensuring that deliverables are met, and should not discourage necessary investment. EME agrees with Ofgem's aim in seeking to ensure that an efficient company should be able to earn a rate of return on its RAV that is at least equal to the allowed cost of capital, and that companies are able to raise finance from the capital markets on reasonable terms.

We have tried in this response to strike a balance between endorsement of positive progress, constructive criticism and reflection / development of alternatives. Immediately following are some brief key headlines and then the more detailed response.

We support the view that **RPI-X regulation** has worked well, thus far. However, the network infrastructure has built into it an inherent resilience, which should not be mistaken as a reflection that current levels of investment are sustainable. For EME, the asset turnover rate at current levels of investment is 140 years, taking us to DR35. Our assessment of asset condition suggests that this rate of replacement is manifestly not sustainable.

EME considers that in order to achieve the principal objective, **capital investment** should be based on network needs through a risk based asset management approach, with regard to network integrity, agreed levels of risk, appropriate quality of supply, price stability, environmental objectives and energy policy.

One of the most important issues is that of **funding**, including accelerated depreciation, tax and pensions. It is essential to ensure that funding mechanisms are correct, which is even more pertinent in the case where increased levels of investment are required. If high capital spend is required, resulting cash flow would be negative for all DNOs under the current financing arrangements. This is clearly not viable and the funding mechanism should address this issue.

We are pleased that Ofgem are considering how to properly fund ongoing **pensions** cost liabilities. With such an emotive and topical issue, identifying any efficient level of cost will need to have full regard for transparency, consistency and fairness. As Ofgem states in the initial consultation, consumers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business. It is our view that the vast majority of any DNO pension deficits are a liability to be picked up by consumers through DR4.

EME agrees that a **review of outputs** required of DNOs would be valuable. We believe that serious consideration needs to be given to the introduction of output measures that focus on the long term stewardship of the network and its inherent integrity and resilience over the longer term. However, any move to inclusion of short term interruptions as an incentivised output measure needs to be treated cautiously as these are inextricably linked to permanent interruptions. Clearly, there is the danger, here, of introducing a perverse incentive, which could drive inappropriate asset management strategies.

We support target setting on a comparable basis, provided that it is clearly linked to and supported by a long term commitment to the required investment on the network. However, we are not satisfied that there is yet a robust methodology for **comparing quality of supply**. Publication of quality of supply comparison attributed to companies, in October 2003, would

be misleading. More importantly, it is imperative to consider where to best focus efforts and whether consumers would be willing to pay for such comparison or if they would receive better benefit from sustainable investment in the network for the medium to long term.

Furthermore, any **target setting** solution will need to take account of inherent variability in performance. The application of deadbands to the targets is our preferred method which we believe will become absolutely essential as companies close in on their long term targets. In the end it should be for individual negotiation as to the acceptability of targets linked to capital / operating allowances and any associated incentivisation schemes.

EME is supportive of Ofgem's intention to use a range of techniques to **assess costs**. However, we believe an important stage is missing from the process described. It is essential that Ofgem enters into discussions with DNOs to develop a comprehensive understanding of the data provided, so that informed decisions are made. Furthermore, we are concerned regarding the possible loss of transparency in the process. EME have expressed support for evaluation of a **total cost quality** approach in principle, but practical issues, which probably preclude formal implementation in this review, need to be recognised. In particular the treatment of capex requirements is not straight-forward, since capex requirements are company specific and are influenced by historic allowances.

EME welcomes confirmation that the 5 year **retention period for efficiency savings** will apply to capex as of 1 April 2000 and that Ofgem intends to introduce fixed retention of opex efficiency savings from 1 April 2003. However, the treatment of opex savings prior to this date needs to be confirmed and it is necessary to consider the interaction between this mechanism and the 5 year reviews, and ensure efficiency savings are not counted twice.

On **force majeure and exceptional events** there has already been considerable correspondence in which EME has demonstrated its commitment to developing a fair and equitable process which better meets both company and importantly consumer need. We will continue to pursue this objective.

East Midlands Electricity is supportive of the introduction of **competition in connections**. We believe that until the legal framework surrounding live working is resolved, the current split between contestable and non-contestable activities should remain, with live working remaining non-contestable.

To conclude, the asset base is ageing, with consequential links to its inherent condition, and replacement of these assets requires a long term, co-ordinated approach in order to minimise disturbance to consumers, protect security of supply, ensure adequate skills resources are available and best manage possible price fluctuations. In reviewing and setting the many aspects of the price control, it is essential to ensure linked issues are dealt with in the appropriate order and to review the sum effect of the incentives on DNOs and ensure that they are consistent with required deliverables and that there are no perverse incentives, double hits, or penalties for anything which is outside a DNO's control.

I look forward to discussing the views expressed in this response at your convenience. If you wish to do so or wish to seek further clarification please contact me via email or telephone, on 01332 393301.

Yours sincerely,

Paul Eveleigh
Commercial and Regulation Manager

Electricity Distribution Price Control Review - Initial Consultation Response by EME, 22nd August 2003

The detailed response below broadly follows the structure of the initial consultation document. Comments pertaining to the initial conclusions document are incorporated under the relevant section or highlighted as a response to a specific section in that paper.

EME appreciates the progress made in the first phase of the price control looking at the network monopoly price control framework, particularly the progress that has been made in joint industry – Ofgem working groups. It is encouraging to see that Ofgem intends to take these groups forward throughout the DNO price review process, particularly the incentives and uncertainty work and the work on quality of supply. The paper lists 3 key issues, which are ‘dealing with uncertainty’, ‘developing the regulatory framework to deal with increased levels of distributed generation’, and ‘the design of an appropriate overall incentive framework for the DNOs’. EME concurs with the need to address the issues listed.

HARMONISATION OF PRICE CONTROL REVIEW DATES

EME would like to add a comment for consideration in the discussion on harmonisation of price control review dates. There are advantages to keeping reviews spread out: it should enable regulation to evolve in stages and enable Ofgem to maintain a more experienced team than if demand for regulatory expertise were peakier.

FORM, STRUCTURE AND SCOPE OF THE PRICE CONTROLS

As stated, RPI-X regulation has worked well, thus far. Consumers have enjoyed real benefits as a result of RPI-X regulation; improved asset management has enabled the industry to lower prices to consumers. However the service consumers enjoy is the result of past, as well as current, investment levels. The network infrastructure has built into it an inherent resilience, which should not be mistaken as a reflection that current levels of investment are sustainable. For EME, the asset turnover rate at current levels of investment is 140 years, taking us to DR35. This is manifestly not sustainable.

In addition, the introduction of the IIP was an acknowledgement that the achievement of cost reduction should not be to the detriment of longer term objectives, such as ensuring network stewardship.

The need to invest in the infrastructure is apparent and the price control framework needs to reflect this, particularly in establishing appropriate funding mechanisms. A proper risk based approach is needed to identify what needs to be done, then the use of RPI-X should be in ensuring that is delivered efficiently. The RPI-X incentive should not discourage necessary investment.

Revenue Drivers

We perceive the existing growth driver under price controls to reflect Ofgem’s view of the extent to which DNO costs are variable with volume distributed, and we have adopted tariffs that reflect this revenue driver.

The current ‘50% volume driver’ has worked well to date, and careful consideration would be needed before introducing change. We do not consider there to be strong indications of a need for change at present. However, increasing volumes of distributed generation and environmental initiatives to reduce demand may well cause volume growth to slow or even reverse within the period of the next price control. It will therefore be important, in setting the next price control, to ensure appropriate assumptions are made about volume growth.

It is possible to imagine that, in the longer term, the main purpose of distribution networks will not be to shift large volumes of units, but to provide security of supply to consumers that are

partly self-sufficient. In this scenario the need for and importance of the network might well remain the same, but the cost would be driven almost entirely by capacity, and revenue would have to be recovered on the basis of capacity rather than units distributed. In this event the volume driver would no longer be appropriate.

Competition in Connections

EME is supportive of the introduction of competition in connections. We are active on the inter-DNO group that has been set up to deliver common industry adoption processes that are workable, transparent and which work for all parties, in the light of the DTI's perspective on DNO's liability for adopted assets.

We believe that until the legal framework surrounding live working is resolved, the current split between contestable and non-contestable activities should remain, with live working remaining non-contestable.

We do not believe the price control needs to be extended to cover the non-contestable element of the connection charge. The distribution licence already prohibits discrimination between consumers, other than on the grounds of cost, when providing a connection charge. A company breaching this licence condition would be subject to a fine under the Utilities Act, and we believe that this is sufficient to ensure companies satisfy themselves that their systems and processes are robust.

In addition, DNO's licence condition 4, statement of charges for connection to our network, includes a schedule of charges for non-contestable items. This statement is seen by Ofgem prior to its publication.

We believe that to properly facilitate competition in connections, and the split between contestable and non-contestable connections, requires an appropriate organisational structure and inevitably incurs some costs. Ofgem's consideration of reasonable costs as part of the price review should take account of the different approaches companies have taken. Whilst we recognise there are commercial decisions to be made by companies with regard to the level of risk they are prepared to take and the organisational structure they choose to adopt, Ofgem must allow companies a level of costs sufficient to accommodate competition in connections in a way that allows them to comply with their legal obligations. It should be recognised that this is unlikely to be the lowest cost model.

EME is currently working to Ofgem's draft standards of performance on the provision of quotations to consumers, and we believe that this aspect of a company's performance is best measured using an Overall Standard. However, it should be remembered that if a large consumer, for example a street lighting authority, were to submit a volume of enquiries vastly different from normal work patterns, even the most efficient DNO would struggle to meet its standards. In order to prevent this situation from occurring, EME is building solid working relationships and working towards two-way service level agreements with its key consumers, in order to manage the work loads coming in, and hence improve the service we are able to provide.

Fixed Retention Period for Efficiency Savings

EME welcomes confirmation that the 5 year retention period for efficiency savings will apply to capex as of 1 April 2000. We welcome the fact that Ofgem no longer intend to put in place a mechanistic link between capex retention and performance against quality of supply targets, particularly since the targets were set with regard to past performance and other companies' performance rather than the link between investment and performance improvements. Furthermore, the introduction of the IIP has highlighted inaccuracies in past reporting for some DNOs and, thus, shown that the method for target setting at DR3 was totally invalid.

It is, of course, important that outputs feed in to Ofgem's assessment of efficiency, and that Ofgem sets out some criteria/guidelines relating to assessment of efficiency for this review period and the DR4 period. The Initial Conclusions document (section 3.57) discusses possible treatment of overspend, however further clarification is not given in the Initial Consultation paper. Clarity in the area of assessment and treatment of over/underspend including the link to outputs, would promote confidence that sound management decisions will not be penalised, and prevent weakening of incentives due to uncertainty. Any assessment should not override the principles set at DR3, where the concept of commitment to a year by year investment programme was not established.

EME supports the method for adjusting the RAV put forward by a group of DNOs and referred to in the paper. We believe this model is appropriate since it has been developed to deliver Ofgem's requirement to strengthen incentives for capital efficiency, address the periodicity issues and meet the commitment given by Ofgem in the December 1999 DPCR3 final proposals.

EME welcomes the confirmation that Ofgem intends to introduce fixed retention of opex efficiency savings from 1 April 2003. However, the treatment of savings prior to this date need to be confirmed and it is necessary to consider the interaction between this mechanism and the 5 year reviews, and ensure efficiency savings are not counted twice.

Treatment of Non-Operational Capex Savings

We welcome the proposed evaluation of the benefits of inclusion of non-operational capital expenditure in the RAV, and clearly this will be part of the overall funding debate and it is essential that funding mechanisms are correct to allow the necessary increase in investment. Issues for consideration should include:

- the definition of non-operational capex
- the life over which such expenditure would be depreciated, this should be in line with the life of the asset e.g. 3 to 5 years for IT spend
- the appropriate rate of return
- the treatment of allowance currently within the standard controllable operating costs
- treatment of under/over spend, and
- treatment of other investments that lead to savings, such as restructuring costs.

Improving the Incentive and Price Control Framework

Fundamentally, the form of the incentive and price control framework should allow the objectives to be met, and, therefore, incentivise DNOs to deliver appropriate outputs at appropriate prices.

DNOs respond to the incentives provided by the regulatory framework and it is important that Ofgem considers carefully what it is DNOs should deliver before finalising any incentive mechanisms. It is imperative that the price control framework provides clear consistent objectives and deliverables to DNOs in the longer term, and that commitments made via regulations and at the time of price controls are not disregarded throughout the review period or in the following price review. Uncertainty beyond each 5 year price control period weakens incentives. In addition, network investment incentives need to be strengthened in order to allow companies to properly balance risk and reward over the life of the asset.

Significant changes in the industry and externally have increased risks and need to be reflected in the price control framework. The fundamental need to invest in the infrastructure is apparent. It is essential that the incentives and price control framework enable DNOs to manage the asset infrastructure to ensure network integrity; to achieve this it must allow suitable funding mechanisms and a rate of return that will encourage investment in the industry.

It is important that the incentive to invest in the network is aligned with the drive for “re-wiring Britain”. In an increasingly international market for capital, it is not likely that the required level of investment will attract investors unless returns are substantially higher than currently allowed levels. Whilst we appreciate the need to develop robust incentives to facilitate meeting the government’s targets on renewables and to facilitate competition in generation, it should not be to the exclusion of incentives to ensure necessary sustainable investment in the infrastructure. We should not lose sight of the fact that the majority of electricity will still come through traditional routes for some time. Furthermore, the next DNO price control review needs to ensure that companies are in a position to invest in training, college / graduate intake and succession planning within companies to ensure the skill base is adequate for re-wiring Britain.

It is important to review the sum effect of the incentives on DNOs and ensure that they are consistent with required deliverables and that there are no perverse incentives and no double hits. Ofgem should ensure that regulatory policy and incentives align with the aims of the Government’s Energy Policy.

EME would concur that better than average performers should earn an above average rate of return and consider that this not only reflects a competitive market but would also incentivise continuous improvement. However, we would not necessarily extend that view to more specifically rewarding ‘best’ performers, not least since the definition and judgement of what is ‘best’ performance is not straight-forward. Nonetheless, any benchmarking exercise must be robust and equitable to avoid unclear or perverse incentives.

QUALITY OF SERVICE AND OTHER OUTPUTS

EME agrees that a review of outputs required of DNOs and preferred by consumers would be valuable. It is necessary to go back to first principles and consider what the GS, OS and IIP are designed to do for consumers and how to incentivise companies appropriately. It should be noted that inconsistent, unclear, needlessly complex and time consuming processes for determination on exemptions and penalising companies for something that is outside their control weaken the incentive considerably.

In particular, we would support a proposal for an exemption mechanism for Guaranteed Standards, which allowed for the reimbursement of GS payments made to consumers should exemptions apply. Thereby, simplifying the process from a consumer’s point of view, since they would not need to understand the exemptions specified in the regulations. However, this would require a clear objective test for exemptions together with a mechanism which allows automatic recovery of costs, to ensure that DNOs are not exposed to significant additional risk.

In reviewing output measures, it is important to take into account the practicality of measuring, monitoring and incentivising each measure to ensure that the cost of introducing new measures is commensurate with the benefit to consumers and the environment. It is equally important to ensure companies are only incentivised on outputs that they can control. Considerable effort was put in to aligning accuracy and definitions of the current outputs and it may be even more onerous to ensure consistent and accurate measures for the environmental outputs proposed such as emissions of SF6, amenity issues and water pollution from leakage from oil filled cables.

There is ongoing concern regarding the effect of severe weather and other exceptional events on supply to consumers. In the current environment of increasing use of and dependency on high quality electricity supplies, consumers are less willing to accept any interruption to their supply. There are many pertinent examples of a change in consumers’ expectations where the current quality of supply levels had previously been acceptable, such as the conversion of former farm properties in rural areas into office units. In relevant meetings, Ofgem has

expressed concerns that a change in weather patterns i.e. an increase in adverse weather affecting the network, would mean that the exceptional weather we see now may become the norm.

Nonetheless, electricity distribution networks were designed and built to the standards that were acceptable more than 50 or 60 years ago. They are not designed to withstand extreme weather. If expectations are that distribution networks of the future should withstand a greater range of weather conditions then significant investment is needed. As with all investments of this type there is a cost/quality or cost/risk trade-off. At DR3, Ofgem rejected EME's capex proposals, which would have given a step change in performance. Ofgem expressed the view that EME's overhead line network did not need to be replaced. Therefore, the inherent performance of an overhead line network with its existing age profile and vulnerability was accepted. Capital investment is peaky and one of the consequences of low investment levels for the DR3 period is that a step change in quality of supply improvement is not now possible for the comparable levels of investment as proposed at DR3. If outputs and incentives for the resilience of DNOs' networks are to be introduced, then the investment required to make the proposed improvements and the time needed to carry out the work should be identified and allowed for.

EME has actively participated in the DTI's Network Resilience Working Group following the October 2002 storms, and believe the emerging conclusions will be a valuable input to this debate.

We believe that serious consideration needs to be given to the introduction of output measures that focus on the long term stewardship of the network and its inherent integrity and resilience over the longer term. In particular consideration should be given to including the reliability measures currently reported in the Medium Term Performance Report under the IIP provision in those outputs that are used to judge performance of the companies. The Asset Risk Management Survey has an important role to play in this arena and we comment in further detail on the role it should play in the forthcoming review in the section on assessing costs. Additionally, the move to inclusion of short term interruptions needs to be treated cautiously as these are inextricably linked to permanent interruptions. In many cases these performance outputs are the result of responding automatically to incidents on the network in order to minimise disruptions to consumers e.g. during lightning strikes. Clearly, there is the danger here of introducing a perverse incentive, which could drive inappropriate asset management strategies.

The asset base is ageing, with consequential links to its inherent condition, and replacement of these assets requires a long term, co-ordinated approach in order to minimise disturbance to consumers, protect security of supply, ensure adequate skills resources are available and best manage possible price fluctuations.

EME considers that in order to achieve the principal objective, capital investment should be based on network needs through a risk based asset management approach, with regard to network integrity, agreed levels of risk, appropriate quality of supply, price stability, environmental objectives and energy policy. The asset risk management survey should give comfort that DNOs are best placed to manage the network effectively. EME believes that the tools it has developed in-house, condition analyser, performance analyser and risk register, are best in class and will lead to development of a robust capital investment forecast with explicit risks which cannot be ignored. Therefore, the network need is clearly demonstrated and the incentive regime should be one which allows network needs to be met efficiently.

Incentives for speed and quality of telephone response

EME expressed concerns prior to the introduction of the IIP regarding the telephone survey and its restriction to surveying those consumers who have spoken to an operator. We have

an effective messaging system and consumers who are satisfied with the message they receive when telephoning our emergency loss of supply number will not speak to an operator and therefore the sample is bias towards those who are the first callers notifying us of an incident, have more information to pass on to us, or are not satisfied with the telephone messaging system.

It is vital that any consumer research is robust, therefore we would support the move to sample all our consumers who have reason to call our emergency telephone number.

The speed of telephone response is a valid output measure, provided it can be measured consistently and accurately across the industry. We support the principle of improvements in each individual DNOs speed of response, however, a degree of rationality is needed; there is no value to consumers of improving from a timescale which is considered an acceptable level. It may be more appropriate to simply monitor speed of response and introduce targets if the speed of response reaches an unacceptably low level.

Comparing Quality of Supply

As outlined in our final response to the IIP Proposals (IIP Incentive Schemes Initial Proposals – a response dated 15/8/2001), we share the aspiration to be able to compare network performance. It is our belief that as a long term goal the comparison of normalised CML and CI results across the industry should be achievable, provided the method of normalisation is transparent, simple for all to understand and interpret and demonstrably non-discriminatory.

In our letter of 12 November 2002 responding to the October 2002 document “Comparing Quality of Supply”, we fully supported the work proposed both to understand the drivers behind quality of supply and to develop a methodology by which the quality of supply of the DNOs could be equitably compared. We also shared the aspiration that any methodology developed could be used in a process by which robust and equitable quality of supply targets are set across the companies linked with the appropriate incentives to deliver these targets = a total end to end process.

We consider that the joint Ofgem/DNO working group “Comparing Quality of Supply Performance” has provided an excellent forum in which both Ofgem and the DNOs have been able to work together to understand the complexities of the numerous facets and drivers that underpin electricity networks’ performance. We consider that the group will continue to provide an appropriate forum in which to examine which factors are appropriate, whether any weighting adjustment is appropriate between factors and to assist in shaping the October 2003 document. The joint understanding has facilitated discussion on how any eventual gaps in performance that may be identified can begin to be closed if so required. We therefore look forward to our continuing involvement with this group both to guide the work and also to establish the linkage between quality of supply performance and the other elements in the price control review process.

In refining the mechanism currently in development, for comparison of quality of supply, we consider that account needs to be taken of the following issues:

- there is potential for placing undue reliance on the one year’s data forming the main input into the determination of comparative performance. We urge caution in this approach and stress that it will be essential to examine ways in which historical data can be used to support any comparison so formed
- consideration needs to be given to the validity of using individual company performance data in comparative work, where in fact it may be inappropriate to use an industry wide comparison e.g. inherited factors such as reliability, circuit length and externalities such as regional lightning patterns.

Also, as we have stated on several occasions, we have undertaken extensive work towards developing an understanding of quality of supply using both disaggregation and statistical approaches and have shared the results of this work with Ofgem and the working group. For example, even within an individual company, circuit length / percentage of overhead line and consumer density only explains 25% of variability in performance, with the other 75% of variance being apparently unexplained by any other single dominant factors. The view that we have developed from this work is that even for those factors outside companies' control, progression even to anywhere near a robust methodology is complex and resource intensive. New IT systems and much more detailed data collection than is now provided for would be required. It is therefore for consideration where to best focus this effort and whether consumers would be willing to pay for such comparison or if they would receive better benefit from sustainable investment in the network for the medium to long term.

Consequently, we are not satisfied that there is yet a robust methodology for comparing quality of supply. Publication of quality of supply comparison attributed to companies, in October 2003, would be misleading.

In conclusion we look forward to exploring the issues set out over the coming months in association with the ongoing consultation with the industry.

Frontier Performance and Target Setting

We note the aspiration to define frontier performance based on a comparison of network performance across the companies. However, we consider that the ability to correctly identify the frontier performance from this comparison is predominantly dependent on the following guiding principles:

- a sufficient number of years of RIG compliant network performance data so that the inherent variability in network performance can be taken into account
- a robust methodology of comparison (as discussed above)
- a view of the total cost (opex & capex) of the performance so identified
- a means of accounting for inherent variability and exceptional events in the future

Before examining these principles in further detail we offer the following comments with respect to the specific options outlined for rewarding best performers:

1) The first option outlined in section 4.31 appears to be proposing a significant amendment to Standard Licence Condition 49, where currently the reward for out performance depends on rate of improvement and meeting both the CI and CML 2004/05 targets. Naturally, any change to a licence condition must follow a due process, and we consider it is actually out of scope for the electricity price control review. We would, however, be happy to contribute fully to a proposal to change the IIP incentive scheme as outlined in this paper.

2) We consider that the second option is potentially a valid basis from which rewarding of best performance can be considered provided that the level of investment allowed is commensurate with the targets set and that frontier performance can be robustly and equitably identified. We would urge extreme caution in identifying frontier performance from the methodology currently developed for comparing quality of supply and indiscriminately applying for example the view that upper quartile performance is naturally "frontier performance".

We concluded in the section on comparing quality of supply that robust and equitable comparison requires additional data sources in order to develop a far more detailed understanding of circuit performance than we presently have from the current state of knowledge. This is unlikely to be the position for many years to come and the consequent uncertainty that is introduced by less than perfect methodologies should be taken into account

when judging just what is meant by “frontier performance” and how it should be rewarded. Also, comparison of network performance, even when adjusted for factors outside a companies control needs to be judged alongside the cost at which that performance is achieved. Otherwise, as was acknowledged during the work on the Asset Risk Management Survey where there is a need to examine the linkage between the processes and their costs, a potentially serious misjudgement of exactly what constitutes “frontier performance” can occur. The principle must be that frontier performance is judged in an equitable way that avoids introducing any perverse incentives.

Additionally, once the end targets are identified, which we consider must be by taking a long term view, the issue of the investment needed to achieve the change still remains. Target setting needs to be an end-to-end process as network performance is inextricably linked to investment levels, past, present and future; only over the long term can companies take steps to mitigate the impact of inherited network characteristics. In the short to medium term, at current rates of asset turnover there is virtually no control over the inherent design of the majority of the network. In the absence of consumers’ willingness to pay to remove the inherited differences, asset lives determine the efficient replacement rate. In many respects underlying network performance was set many years ago. In addition, there has been no cost benefit analysis to demonstrate the value, if any, of incentivising companies to make changes to their underlying network characteristics in order to align performance across the UK. In a truly competitive market, consumers are able to choose what they want and at what price from commercially viable available ranges. The service/product and price are inextricable linked.

Finally, any target setting solution will need to take account of inherent variability in performance. The application of deadbands to the targets is our preferred method which we believe will become absolutely essential as companies close in on their long term targets. Companies may be able to influence the underlying trend in performance through consistent improvement but the nature of electricity distribution and its inherent risks mean that there is not sufficient control to steer to or keep at absolute targets year on year.

To conclude, therefore, although we agree that anything done mechanistically with regard to target setting needs to be simple to understand and apply, this aim may be totally at variance with the complexity of the area under consideration. Consequently, in the target setting approach finally adopted, there should still be a significant involvement of each DNO in setting the “contract” by which both the target to achieve and investment to enable its delivery are agreed. In the end it should be for individual negotiation as to the acceptability of targets linked to capital / operating allowances and any associated incentivisation schemes. We would suggest that this is an area where the joint DNO/Ofgem working group can work together to ensure that in any future incentive scheme and price control review inherent variability is adequately taken into account using an approach acceptable both to Ofgem and the distribution companies.

Development of the GOSPs

In reviewing the GS and OS, it is important to keep in mind the principle behind these standards and what they are designed to do for consumers.

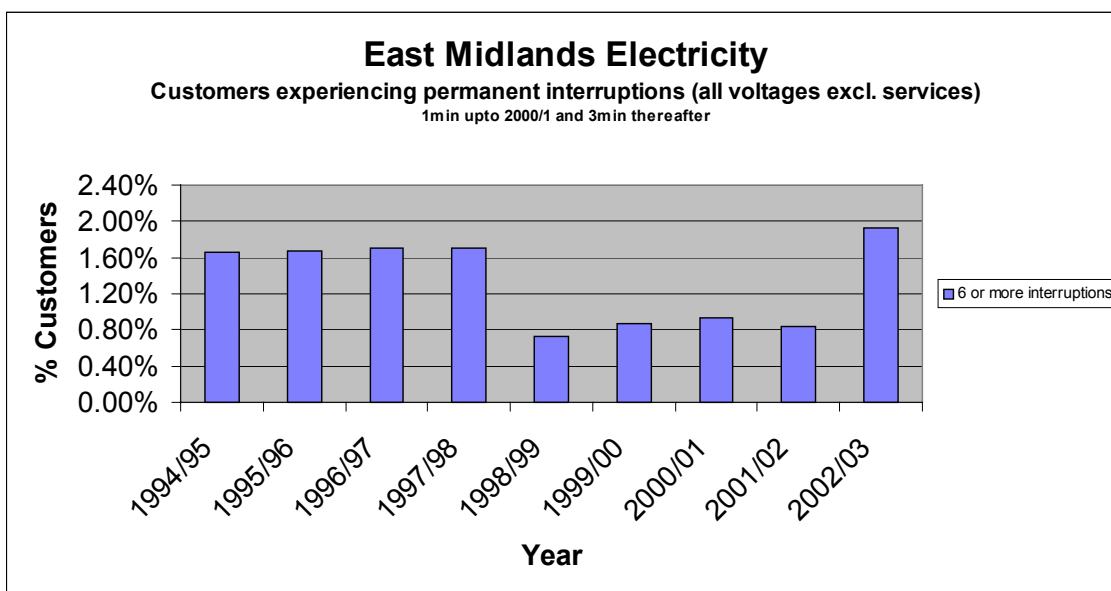
Overall Standards should place in statute achievable and reasonable minimum standards of service, failure of which would result in a penalty to the company. The mechanism is not designed to incentivise improvement rather to guard against clearly unacceptably low standards. The introduction of any of the current Overall Standards into the IIP needs to be carefully considered, in terms of whether the output is appropriate, can be accurately measured and enhances rather than complicates or negatively influences the overall incentives on DNOs.

In the case of Guaranteed Standards, the principle is that consumers are compensated when DNOs fail to meet standards which should be achievable. Therefore, it ought to be possible to have no cause to make any Guaranteed Standard payments in any given year. They are primarily a mechanism for expressing our apologies to the consumer as opposed to a penalty / incentive to the company. There are better mechanisms which could be used for incentivising companies to improve the level of service, one example being the IIP. It is not necessarily appropriate to extend current standards or introduce new measures, which may simply result in all consumers effectively funding insurance for payments to those consumers making a claim. It would be better to consider how consumers may fund investments in the network which would represent a true improvement and result in fewer GS failures, thus benefiting all consumers. Furthermore, in line with competitive industries, GS penalties should bear comparison with the average annual charge to a consumer for distribution services. i.e. ~£50/yr. To illustrate the point, no consumer would expect free flights for a year following cancellation / long delay, or indeed reimbursement of the cost of that one flight.

Multiple Interruption Overall Standard

This overall standard was introduced in the current price control period and has different targets for each company to achieve. At the time of introduction, it was expected that these would be aligned in the future. We would urge caution with regard to tightening the standard, in particular that set for the majority of companies at 98% of consumers not to receive more than 5 interruptions in a given year. It may be necessary to align the standard to 96% for all companies, but as discussed below a tightening of the standard to anything over 98% is not appropriate for any DNO with significant overhead line.

The year 2002/2003 has seen some exceptional weather and it has been apparent that the multiple interruption overall standard does not have the generic nor specific force-majeure exclusions of the guaranteed standards, except for one exclusion provided by the reference to the Regulatory Instruction and Guidance definitions for an interruption under the IIP scheme. Consequently, there are virtually no significant exclusions and without these any tightening of the 98% standard for companies with significant OHL populations would be difficult to achieve on a consistent basis. There is a need for a deadband which is presently achieved by the current target, which caters for the natural variability in performance. We have long monitored this particular performance indicator and the graph illustrates the historical variability for EME showing the significant differences experienced over the years. For the reasons outlined the 98% target should be seen as the top limit for OHL based networks.



Multiple interruption Guaranteed Standard

It is clear that Ofgem see the guarantees of service as a means of compensating consumers for unacceptable levels of service and companies believe the Guarantees should be achievable in line with the Electricity Act, which states the standards “ought to be achieved”.

The threshold set is not considered to be achievable and would prevent us from being proactive or from having adequate control over performance levels. EME considers that the standard should be set at a level which can be attained, rather than a level which simply causes high levels of compensation payments.

Treatment of exceptional events

Although we recognise that processes for determining exemptions for exceptional events may necessarily be different for the IIP, GS and OS, and that specific exemptions are relevant to specific standards, the underlying principle of force majeure should be consistent across all measured, monitored and incentivised outputs. The principle being that companies should not be penalised for something which is outside their control. This is not something used exclusively in network monopoly businesses, and the introduction of further comparison and competition means that it is ever more important that the industry and Ofgem develop appropriate, clear and consistent exemptions.

No matter what the change in weather patterns or consumer expectations, the principle behind ‘force majeure’ and exemptions is that DNOs are not penalised for something which is outside their control. Not only should arrangements be consistent across standards, it is also imperative that a clear consistent message is given to consumers.

The GS, OS and IIP were introduced to benefit consumers and incentivise companies. In reviewing the outputs and incentives and developing processes to take account of exceptional events, the overall aim of these mechanisms should not be lost. It should be noted that inconsistent, unclear, needlessly complex and time consuming processes for determination on exemptions and penalising companies for something that is outside their control weaken the incentive considerably. Furthermore, revision of commitments made in regulations and licence conditions after any specific event, introduces uncertainty and unacceptable risk.

The arrangements for determination of force majeure under IIP for weather related events are under consideration separately and EME have met with Ofgem on several occasions to contribute to the development of a suitable process. EME consider that much progress has been made in developing the process and are supportive of the proposal presented at the recent Ofgem workshop. Our initial view is that the method proposed is the one that should be applied and then refined, if necessary.

Interim measures for this price control period for exceptional events

The introduction of any interim arrangements should not undermine regulations and licence conditions already in place. Post event changes to the treatment of exceptional events / agreed exemptions cause confusion, weaken incentives and can expose companies to unacceptable levels of risk.

It is of value to DNOs, consumers and Ofgem to have arrangements in place which are consistent, clear and do not weaken incentives by introducing uncertainty or penalising companies for something which is outside their control.

Our views regarding the October storms determination have been expressed in our letter to Andrew Walker, dated 30 July 2003.

Changes regarding the definition of an exceptional event, and proposal to judge companies' emergency plans and application of those plans during an exceptional event should be subject to full consultation as part of the proposed review of the outputs framework. Introduction of interim arrangements is outside of the price control review.

Electricity distribution networks were designed and built to the standards that were acceptable more than 50 or 60 years ago. They are not designed to withstand extreme weather. If expectations are that distribution networks of the future should withstand a greater range of weather conditions then significant investment is needed. As with all investments of this type there is a cost/quality or cost/risk trade-off.

The design and maintenance of the distribution network for resilience to severe weather should, therefore, be considered as part of the forecast BPQ. EME would welcome introduction of outputs and incentives regarding the resilience of DNOs networks provided the outputs can be consistently and accurately measured, are pertinent, that any judgements or benchmarking are robust, and sufficient investment is allowed to carry out required improvements.

Consumer Research

The working group meetings on developing a consumer survey and assessing consumers' willingness to pay have proved a useful forum for debating the relevant issues. It is encouraging that Ofgem and the DNOs seem to agree that any consumer research must be robust and results must be given an appropriate weighting when considered alongside other factors such as government policy and network needs.

Our view is that the research needs to be broad in its outlook, not concentrating on achievement of the Guaranteed Standards. We should be asking consumers how prepared they are to pay for wider environmental gains, for example undergrounding of overhead lines in areas of outstanding natural beauty. We should also be looking to elicit consumer attitudes to more strategic questions about cross-subsidy to ensure worst-served areas receive similar levels of service as better-served areas. Or to delve into issues of price stability, and willingness to invest in network integrity for future generations. Moreover, it should identify consumers' preferences without a steer, and provide a sense of perspective of the services provided by DNOs relative to other concerns.

The information from the focus groups suggested that consumers see outages as beyond distributors control and give a high priority to restoration and communication as opposed to a view that power cuts should not happen. Consumers' willingness to accept should therefore be explored, in terms of when they find it acceptable to be off supply, what they consider to be appropriate circumstances for exemptions from normal expectations and, their views on funding compensation vs. funding improvements.

There is a danger of confusing what matters most to consumers within their own experience of services, with what they value, or is valuable to society, and their willingness to pay. The willingness to pay work should offer the potential to get consumer views on the value they place on issues as outlined above, rather than concentrating on minor changes to existing incentive schemes. Furthermore, when seeking the consumers' views on willingness to pay, it is important that they respond with the understanding of the proportion of their bill that is for the infrastructure i.e. ~£50 per annum. EME supports the use of stated preference techniques to elicit consumers' willingness to pay.

As Ofgem is aware, it is not possible to offer consumer specific services in electricity distribution. However, it is unlikely that a survey will show a consensus of opinion on all issues across all consumers and regions. The resolution of conflict needs to be addressed.

Finally, there is now an existing energy policy framework and there are statutory requirements for network design standards, particularly on health and safety issues. It would be nonsensical to set the focus of any consumer survey on such issues, since it is not the intention to re-write such policies and standards. It should, however, be recognised that compliance with new obligations, for example the Electricity Safety Quality and Continuity Regulations, and lane rental, drive costs up. In any survey the depth of understanding of the 'product' determines the quality of the responses. It should be noted that the majority of consumers are not aware of long term investment issues or risks of short term gain, i.e. unsustainably low prices now may necessitate high recovery costs should the current levels of system risk and performance be allowed to become unacceptably low. Therefore, societal value of energy delivery systems for both present and future consumers are better assessed elsewhere and will in any case require leadership to drive appropriate alignment with overall energy policy objectives. Results from a consumer survey would then be used to understand marginal preferences.

DISTRIBUTED GENERATION

EME has responded separately to the two recent related documents, "Structure of Electricity Distribution Charges – Initial Conclusions", published June 2003, and "Innovation and Registered Power Zones – A Discussion Paper", published July 2003. We have taken part in the consultation process on distributed generation and have met with Ofgem to discuss this topic in more detail. Therefore, we have included in this response only a high level summary of our views, and, as always, would be happy to discuss further with Ofgem. EME will fully support and participate in further consultations, workshops and meetings.

The Government's Energy Policy has introduced challenging targets, which will likely be met by significant increase of distributed generation. This increase introduces fundamental uncertainties into the management of a distribution network. The industry has been working to understand the technical issues, via the DGCG and TSG, however, the uncertainties will remain for some time and there will inevitably be increased risks to DNOs. It is necessary to identify the increased risk along with other new risks, appropriately allocate and develop new incentives for managing the risks. It is imperative that all such risks are appropriately accounted for in calculating the cost of capital.

The regulatory framework will need to enable DNOs to facilitate increased connection of distributed generation, but should not penalise DNOs should there be low penetration of DG or stranded assets, which are both clearly outside the DNO's control.

EME supports Ofgem's proposal to move towards shallower connection charging. However, we believe that key locational signals must be retained to drive economic investment, with generators having to bear some of the investment risk.

EME put forward proposals, for charging distributed generators, in our response to the recent structure of charges paper. These proposals included a move to 'shallowish' connection charges and no ongoing generator UoS charges. We believe these proposals would facilitate achievement of the Government's targets for distributed generation, while retaining appropriate locational signals and minimising costs.

EME accepts that a DNO ought to be able to demonstrate that it provides economic connections, but does not believe that, given the significant uncertainties over costs to connect different generators, a £/MW driver is appropriate at this time, either in whole or in part. EME has carried out analysis which shows that the range of cost of connecting different types of generation at different locations on the network is very wide. Furthermore, any analysis to calculate a £/MW value would have to be based on both generator connections already implemented and those not implemented due to cost of (deep charging) connection. In the past, generators may have chosen not to implement a scheme because of the cost of connection, but may choose to connect under a shallower charging regime, where the

remaining cost of connection would then be borne by the DNO. Therefore, any attempt to derive a £/MW driver based on past connections is invalid.

In addition, to derive an appropriate £/MW value, large volumes of historic data would be required. We are not confident that there is sufficient data yet available to derive a realistic figure. Furthermore, this type of incentive will penalise DNOs where potential for DG is low, since the ability to outperform the £/MW driver can not be balanced against any high cost connections.

It is EME's view that an economic connection can be demonstrated by showing that

- Methods of connection are designed economically (what is to be done)
- Those connections are delivered efficiently (how it is done)

EME therefore proposes a five year spending forecast, based upon DG-BPQ proposals, which would be subject to the two tests outlined above, and which would be reviewed only if the actual levels of generation are higher than originally predicted.

EME recognises the need for an incentive mechanism on network availability, however this should be based on MW capacity not MWh transported. MWh transported is under the generator's control, and provided the network capacity is available such that generation is not constrained, the DNO should not be penalised for cases where the generator chooses, or is not able, to utilise that capacity.

Finally, DNOs should not bear the risk of generators relocating or going out of business. Since DNOs have an obligation to connect, it is important that, once legitimate investment has been made, it is included in the RAV and depreciated over a period of time appropriate for the expected asset life.

ASSESSING COSTS

EME is supportive of Ofgem's intention to use a range of techniques to assess costs. However, we believe an important stage is missing from the process described. It is essential that Ofgem enters into discussions with DNOs to develop a comprehensive understanding of the data provided, so that informed decisions are made. Furthermore, we are concerned regarding the possible loss of transparency in the process. In DR3 the audit trail from data that DNOs submitted to the final proposals was weak.

EME has expressed support for evaluation of a total cost quality approach in principle, but practical issues, which probably preclude formal implementation in this review, need to be recognised. In particular the treatment of capex requirements is not straight-forward, since capex requirements are company specific and are influenced by historic allowances.

EME considers the proposal to review fault costs on a total cost basis to be appropriate due to the differences in DNOs accounting treatment of these costs. However, average fault repair costs will vary enormously dependant on circuit mix overhead to underground, inclusive of overheads as each company defines them, and will vary with performance since fast responses almost always requires overtime costs.

Comparison of DNOs is made difficult due to the operation of different business models and the impact of the degree of in/out- source work on the cost structure of each DNO. Much discussion has taken place between the DNOs and Ofgem concerning the activity analysis included in the RAGs. It is EME's view that this activity analysis does not adequately address the issues which make comparison of DNOs in this way invalid. Furthermore, it should be recognised that there is an inherent risk associated with the disaggregation of data. An apparent low cost activity may not be the result of efficient performance, but be due to

differences in cost allocation between activities, due to different business models, for example. The danger is that disaggregation leads to creation of a virtual company with costs that are impossible to emulate. In the recent meeting, 31 July 2003, Ofgem acknowledged that definitions for each activity need improvement to ensure more consistency. Moreover, it was agreed that comparison between DNOs can only be made on a basis of cost in total.

There was some discussion regarding allocation of IS costs. It is EME's view that IS is a function supporting activities rather than an activity in its own right. For this reason, IS costs should be allocated to activities.

We welcome the intention to benchmark companies in such a way that does not introduce artificial incentives to merge. Benchmarking at both the DNO and "DNO Group" level may be informative, however the key is that companies are treated equitably. The current market structure has added further complexity to the factors that differentiate companies and, therefore, need to be accounted for in any benchmarking exercise.

The use of 14 observations gives a misleading impression of the statistical validity of results found using the data, because the observations are not genuinely independent and are constructed using uncertain adjustments. It may also introduce bias to the results. If 14 observations are used, it would be clear that the results would be affected and their validity significantly overstated, but it would not be clear by how much. Uncertainties in both adjustment and allocation mean that if subdivided merged companies were used to define an efficiency frontier, a very large margin of error would need to be allowed. It seems unlikely that the margin would be smaller than the gap between the estimated efficiency of the merged company and that of other companies. Furthermore, market activity has come about as a direct result of management decisions and, notwithstanding the issues due to such a small sample size, we would, therefore, favour benchmarking of the 8 separately managed companies.

The impact of regulation on distribution networks is seldom immediate, and in an infrastructure business recovery from an overly cost focussed regulatory regime is likely to be onerous, prolonged and costly. Furthermore, benchmarking at a point in time cannot take account of past investment decisions and current asset risk profile.

In the section on review of forecast costs, Ofgem state that "Experience has generally shown that these forecasts have not been sufficiently robust and are less reflective of out-turn costs than the projections Ofgem has made through the price control process." Actual capex tends to be in line with the Ofgem forecast and not individual DNO forecasts purely because a regulated industry is constrained to the allowances. However, the consequence of this is an increase in the inherent risk of network failure, which may or may not be seen in the short term. This is a direct outcome of incentive regulation, which may be at odds with long term sustainable investment, which we believe is essential for long-lived assets.

EME has proactively sought out efficiencies, and innovation in both asset risk management and targeting of available investment. Although such improvements can be carried forward, the level of investment is not sustainable. Indeed, to enable EME to continue to meet the challenges of security, quality and safety of supplies, network risk needs to be recognised and investment levels increased accordingly.

EME welcomes Ofgem's intention to focus on improving their understanding of the methods and assumptions that support our expenditure predictions in the forthcoming updated Asset Risk Management survey. Provided the survey is robust and judgements of the process are made independently of expected / actual company submissions, this should greatly improve Ofgem's ability/confidence to make a well-informed and equitable judgement of the price control review forecast information.

It is important that Ofgem sets out some criteria/guidelines relating to assessment of efficiency for this review period and the DR4 period. It is equally important that due regard is given to outputs in making a judgement of efficient spend. For example, what is efficient spend as opposed to what is underspend, and the treatment of overspend which may be due to necessary investment in the network, rather than inefficiencies. The latter is particularly relevant to load related spend, where we are obliged to connect consumers and maintain the security of the network with no control over load growth or volumes. Clarity in this area would promote confidence that sound management decisions will not be penalised, and prevent weakening of incentives due to uncertainty.

Review of actual costs

Asset risk management survey

We fully support the updating of the 2002 survey during 2003/4 in support of the price review in particular the aim of furthering the understanding of a condition based approach to asset risk management. We have always been fully supportive of the ARM survey in particular the two main aims of:

- Seeking assurance of the quality of asset risk management / stewardship
- Fostering a better understanding between Ofgem and the DNO

and have always emphasised the need for a holistic approach to asset management in particular the need to also consider the inputs/outputs to the process and the judgement of the effectiveness of prioritisation and delivery.

We have been happy to share our views on the development of the survey process with Ofgem and have welcomed the opportunity to discuss the issues in the industry workshop and on an individual company basis with John Scott and his team. In particular, we have suggested changing the balance of the audit specifically with respect to the scope and length of the audit period and the reliance on written responses. This should give more time to understand the processes in detail and highlight what the processes cost and deliver.

The survey undertaken to support the price review process should focus on the asset management processes that drive the asset investment plans in terms of:

- Risk capture / review and quantification assessment
- Linkage between risk assessment and the asset investment need

We believe that the output of the survey should be supportive to the review and not used in any mechanistic way. Asset volumes underpinning forecast capital investment together with the associated determination of risk are specific to individual company assets and we strongly believe that the concept of benchmarking across the industry of what needs to be done is not appropriate. It is appropriate only to benchmark efficient delivery.

FINANCIAL ISSUES

EME contributes to the working group on assessing costs and financial modelling. We note, however, that there has been no work yet on financial modelling that this group has had the opportunity to contribute to.

EME agrees with Ofgem's aims in seeking to ensure that an efficient company should be able to earn a rate of return on its RAV that is at least equal to the allowed cost of capital, and that companies are able to raise finance from the capital markets on reasonable terms.

Traditionally DNOs are seen as relatively low risk businesses and are required to maintain a stable level and trend of key financial ratios consistent with an investment grade credit rating.

It will be necessary to ensure that the price control enables DNOs to continue to meet the required ratios. All new risks should be recognised and appropriate mechanisms introduced to deal with these. Distributed generation is a major new challenge, however, this should not overshadow other risks, such as changes in tax rules, street works, lane charging, insurance and the new Electricity Safety, Quality and Continuity Regulations. Each of these risks has the potential to increase costs by tens of millions of pounds. It is important that appropriate mechanisms and processes are put in place to allow any significant cost increases to be evaluated and taken into account in assessing income. Some of these may be set pre-DR4 or during the DR4 period.

Ofgem should specify the ratios to be used in the financial model and define the calculation. The ratios need to be ranked in order of importance, e.g. vital, 'nice to have'. These ratios should be based on arms length dividend and interest policies. Dividend and interest payments should not be distorted by Group arrangements, the Group should not exploit or subsidise the distribution business. The model should take into account proper tax assumptions, and the need to ensure DNOs maintain the ability to fund pension liabilities.

Positive cash flows are required to allow dividend payments to ensure an appropriate return to equity investors. There are reasons for concern regarding cash flow, which arise out of several factors, each having a detrimental effect:

- The scope for opex efficiency savings is now much reduced
- Any increase in capital expenditure in DR4, required to ensure security of supply and social and environmental objectives are met
- The changes in the treatment of non-load related capital for tax purposes, effective from April 2005
- Interest rates are likely to rise in the future

The changes in the treatment of non-load related tax means that we can expect a significant increase in tax to be paid in DR4 in comparison to DR3, this should be taken into account in setting allowed revenues. In addition, when setting the price control, consideration should be given to the likely increase in interest rates to ensure DNOs have adequate cash available to cover the higher interest charges in future years.

Finally, if high capital spend is required, resulting cash flow would be negative for all DNOs under the current financing arrangements. This is clearly not viable and the funding mechanism should address this issue.

The Cost of Capital

EME welcomes Ofgem's recognition that the expected tax position of each company needs to be considered as part of the financial modelling. We would like clarification on how tax will be treated. EME considers that it is necessary to make full compensation for tax costs and that these should be assessed on an individual company basis. EME concurs with Ofwat in favouring calculation of the cost of capital on a post-tax basis going forwards.

Additionally, some DNOs may have a high level of embedded debt that incurs interest charges at a higher.

Assessing the RAV and the approach to depreciation

EME are in agreement with Ofgem that the RAV should only be adjusted for disposal proceeds.

We are concerned, however, about the lack of clarity on the approach to accelerated depreciation, which could have significant impact on cash flows. EME considers it to be imperative that the option of accelerated depreciation, as applied in some companies at DR3, is maintained, and considered as one of the available funding options for companies.

Treatment of Pension Fund Costs

We are pleased that Ofgem is considering how to properly fund ongoing pensions cost liabilities and have reviewed discussion of this issue in the principles document with interest. With such an emotive and topical issue, identifying any efficient level of cost will need to have full regard for transparency, consistency and fairness.

As Ofgem states in the initial consultation, consumers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business.

It is our view that the vast majority of any DNO pension deficits are a liability to be picked up by consumers through DR4.

Any deficit will have to be funded in conjunction with current employees. Legally the pensioners have first call on the pension fund. Any deficit will therefore be suffered by future pensioners and must be made up by contributions. Only current employees and their employers make contributions. For this reason, there is no value in collecting data on the split between pensioners and employees.

Any deficit associated with non-regulated business employees (e.g. retail / supply employees) arose substantially as a result of regulated employment (pre October 2000) and is therefore, as can be seen with hindsight, a result of under funding from consumers in the past. The deficits should, for that reason, be made up by the consumers through DR4 income to the DNOs. There is, then, no need to collect data on whether pension liabilities attach to distribution or supply employees pre October 2000. It would not, however, be reasonable for consumers to pay for pension deficits that have arisen on employees who have retired since October 2000 and who were employed outside the regulated business between November 2000 and retirement.

In 1997/1998 one of the companies on the 'opex frontier' was taking a pension holiday. This means that the operating allowances set may have been based on no income for pension contributions. Therefore, allowed income would not adequately fund pension costs for all companies and it could be argued that any contributions paid by companies during the DR3 period should be reimbursed in the DR4 period.

It is important that the principle of consumers of network monopolies paying the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, is adhered to. In collecting data on pensions, it is important to understand what is valuable information in this issue, and not to cloud the principle by examining unnecessary details. We trust the above provides clarity on the pensions issue and would be happy to discuss further if necessary.

Additional comments relating to some of the specific points raised in the June initial conclusions document are given below:

Section 2.7:

The example of "gaming the system", given in this section, is not valid. Early pension on redundancy is a right given by statute to employees in employment with DNOs in 1990. We feel that to make such a claim, Ofgem would need to demonstrate that:

- The distributor encouraged workers to leave the industry during the 1990s by making large redundancy payments out of the pension fund;
- The redundancy payments were 'overly generous', in that they exceeded a prudent estimate of the resulting cost saving to the pension fund; and

- The distributor expected Ofgem to react to this accumulating problem by raising future allowed revenues.

It should be noted that:

- During the period in question, companies could prudently have withdrawn pension fund surpluses and used them for other purposes, since those surpluses were essentially money belonging to the companies;
- Companies would have been required by law to ensure that redundancy payments did not deplete the funds available to cover other liabilities of the pension fund; and
- It is most unlikely that the predecessors of the current distributors during the 1990s would have had much, if any, confidence in the prospective link between costs and revenues ten or more years later.

Section 4.33: Although, the intention not to affect the rights that an individual member of a pension scheme has with regard to that scheme or the obligations of the employers or employees to contribute funds to the pension scheme, is expressed in this section. In actual fact, the guidelines will significantly influence willingness to offer defined benefit pension schemes.

Section 4.34: Part of the role of the regulator is to stimulate competitive effects where otherwise there is a natural monopoly. However, comparisons to a competitive business only extend so far. It states “In these sectors, market forces determine how far a company is able to recover its costs from consumers”. However, in all sectors cost increases must be covered, if a company does not recover costs from consumers, either by increasing prices or lowering service levels / quality, it will go out of business. Furthermore, government policy encourages defined benefit schemes, whereas this section is implying that Ofgem wishes to encourage companies to move away from such schemes.

Section 4.35:

Bullet 1: We would agree that consumers should not be expected to pay the excess costs of providing benefits that are out of line with private sector practice except where such benefits are made mandatory, for example via the Electricity Act. Companies are unable to “manage” down the cost of pension provision for staff and pensioners as a result of the Electricity Act 1989 and our on-going obligations. Basing price control allowances on what may be perceived as competitive packages, outside the distribution sector, is, therefore, inappropriate, unless suitable adjustments are made to take account of the differing legal obligations.

Bullet 2: We agree with this principle, however careful consideration needs to be given to the mechanism by which the proposal may be achieved without effectively re-opening price controls.

Bullet 3: The Actuarial Valuation at 31 March 2004 will run for all the Groups (some 26 at present) not all of which have regulated business and it would seem unlikely that the process can be accelerated for just some Groups. Early results would be expected in October / November 2004.

Bullet 4: It is incorrect to say, that previous price controls were based on efficient accounting charges, since they were based on the ‘frontier’ companies’ charge. Furthermore, it is not possible to assess whether contributions made to the relevant scheme in any one year was below price control allowances, since the allowance was not stipulated separately for pension costs.

Bullet 5: The trustees not the company control a scheme's investment strategy. It is important that any judgement of the management of pensions by trustees should not be made with the benefit of hindsight. The chosen investment strategy may reasonably vary depending on the particular circumstances of the scheme. Investment returns lower or higher than the average do not necessarily indicate poor or good management. Paragraph 3 only holds true if the pension fund took a lower risk approach than standard for its liability profile. For example, invested more in bonds which would give a lower return to company, with a likely higher cost to consumers.

Bullet 6: Any deficit associated with non-regulated business employees (e.g. retail / supply employees) arose substantially as a result of regulated employment (pre October 2000) and is therefore, as can be seen with hindsight, a result of under funding by consumers in the past. The deficits should, therefore, be made up by the consumers through DR4 income to the DNOs. It would not be reasonable for consumers to pay for pension deficits that have arisen on employees who have retired since October 2000 and who were employed outside the regulated business between November 2000 and retirement.

Bullet 7: The cost of providing enhanced pension benefits for those leaving the company early is a legitimate business cost. Furthermore, these costs have resulted in lower future employment costs and thus have benefited consumers.