National Grid

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Dear Cemil

Ofgem's initial consultation on Electricity Distribution Price Control Review

This letter sets out our response to your initial consultation on the electricity distribution price control review. There are three areas upon which we wish to comment:

- the treatment of exceptional events in quality of service targets (Section 4.43);
- the hybrid incentive mechanism for distributed generation (Section 5.31); and
- the projection of potential savings from mergers announced during the review (Section 6.43).

We note that many of the conclusions of your June 2003 Initial Conclusions on Developing Network Monopoly Price Controls have also been referred to. Our views on these are included in our response to that document.

<u>The treatment of exceptional events in quality of service targets (Para 4.43)</u>

We note that the consultation proposes a mechanism whereby all disconnections greater than a threshold period will result in compensation payments. DNOs would then recover the cost of these payments through their price controls at a later date, subject to Ofgem assessing whether it is appropriate for the companies to recover these costs.

Exceptional events might result in a large number of compensation payments being made, in addition to the cost of restoring the network. However, if the events leading up to these events are subsequently accepted by Ofgem as being beyond the reasonable control of the networks, then these amounts may need to be recovered through the price control. Therefore, there may be movement of considerable sums from companies to consumers and then back again. We do not believe that the cash flows (from companies to customers and then back again over potentially long periods of time) and regulatory uncertainty implied by these proposals is in the interests of customers or companies. We would therefore suggest that the current exemption arrangements remain for events affecting large numbers of customers.

There are currently exemptions in the Guaranteed and Overall Standards for transmission related events. These events have historically been rare but may have significant impact, particularly upon an individual DNO. DNOs have little control over these risks, other than by system reinforcement in excess of current planning standards, which we would argue is inefficient, or by putting pressure upon NGC's outage plans. Whilst we expect a degree of pressure from DNOs in optimising outages across the DNO/NGC interface, a further increase in incentivisation of DNO quality of supply would appear to

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unbalance this process. Furthermore, it might hinder NGC's ability to take outages at a time when we are projecting increasing levels of construction work to maintain system reliability.

We are therefore of the view that transmission related events should continue to be exempted or, if not exempted, that the DNO should automatically be able to recover the additional cost of compensation payments arising.

<u>The hybrid incentive mechanism for distributed generation (Para 5.31)</u>

We believe that the proposed combined mechanism of a partial pass through of costs plus a £/kW connected revenue driver is an appropriate compromise between dealing with the uncertainty of costs arising from DG and maintaining the incentive upon DNOs to deliver outputs efficiently. Clearly, ultimate acceptability of such a mechanism will depend upon the parameters. We would offer the following observations:

- Where DG projects are certain (i.e. already contracted, under construction or built), then there is no requirement for a premium rate of return. All costs associated with these projects should be allowed for in the RAB or in the underlying assumptions for capex in the main price control - and assumed to earn cost of capital returns as is the case for the other main categories of capex. Therefore, the DG Incentive should act as an adjustment mechanism to reflect variations from review forecasts, rather than as a funding mechanism in its own right.

- The greater the degree of pass through of actual costs, then the lower will be the required premium above cost of capital arising from the combined scheme. Conversely, the greater the reliance upon revenue drivers the greater will be the required premium above cost of capital.

- A £/kWh revenue driver would expose DNOs to the competitiveness of the generation that they have connected. This could result in DNOs preferring to connect high load factor technologies or being penalised or rewarded by future changes in the arrangements for cross-subsidising renewable technologies. We believe that networks should be indifferent to the generation technologies used and, therefore, a £/KW revenue driver would be preferred. A £/kW revenue driver is also more reflective of investment costs.

- Revenue corrections should occur within the review period rather than be logged up to the next review. This will improve the self-sufficiency of the price control, reducing funding constraints and regulatory uncertainty.

<u>The projection of potential savings from mergers announced during the review (Para 6.43)</u>

Ofgem suggests that it "will consider further whether projections of costs should take account of prospective savings from any mergers announced during the price control review …" Such a proposition would not seem to sit easily with Ofgem' stated policy to:

- not distort merger decisions through regulation; and to
- treat merger savings like any other savings.

Ofgem is already proposing to impose a tax on merging companies (to compensate for loss of benchmarking benefits for customers) and to encourage efficiency savings through a rolling five year mechanism. It is not clear that trying to **anticipate** merger savings sits comfortably in this context.

Please get in touch if you would like to discuss any of these issues further.

Yours sincerely

Tim Tutton
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