



**EAST MIDLANDS ELECTRICITY'S
RESPONSE TO OFGEM PAPER
ELECTRICITY DISTRIBUTION LOSSES
INITIAL PROPOSALS JUNE 2003**

Introduction

East Midlands Electricity is pleased to respond to Ofgem's paper Electricity Distribution Losses, Initial Proposals, June 2003.

We note that Ofgem's initial proposals correspond in many respects with the views we expressed in our response to the earlier consultation paper. We believe the proposals form a reasonable basis for the future incentive, but note that a considerable amount of work is needed around the 'technicalities' before the final incentive can be set.

Our response to the proposals is broken down under the following headings:

- Form of the incentive
- Treatment of additional capex
- Valuing loss reductions

Form of the Incentive

We agree that the best measure of DNO's performance in controlling losses is an estimate of the actual level of losses. We think it important that there is a direct link between the actual level of losses and the associated reward / penalty, and are therefore pleased that you favour an output based incentive.

Although we proposed a losses target based on a twenty year rolling historic average, we are reasonably comfortable with the concept of a fixed 'benchmark'. However, important details remain to be clarified about the way in which this benchmark will be calculated.

We are pleased that our proposal for a simpler definition of network losses is to be adopted – essentially losses should be defined as the difference between everything that flows into the network and everything that flows out, all measured at the points of connection. As indicated in your proposals, care will be needed in establishing appropriate benchmarks. In our letter about 'Embedded Generation Saved Losses' (1st September 2003) we made detailed comments on the methodology proposed for the calculation of compatible benchmarks.

Treatment of additional capex

We welcome Ofgem's reassurance that it "does not intend to disallow from the regulatory asset base any expenditure that is efficiently incurred by DNOs in order to reduce losses". This should enable investments to be made with confidence, provided there is clarity about the meaning of 'efficiently incurred'. In our view, investments should be considered efficient where the 'benefit to society' (i.e. the NPV of the reduction in future losses over the lifetime of the assets), exceeds the investment cost.

Valuing loss reductions

We agree that losses should be valued on the basis of the average wholesale price of electricity, plus the costs of transmission and distribution to the point of loss, and environmental costs that are not included in the price of electricity.

We agree that the value of losses should be reviewed no more frequently than every five years. Certainty about the level of any incentive is important to DNOs when making investment decisions.

We also agree that the level of the incentive should be based on the marginal cost of technical losses as these form the vast majority of reported losses.

Conclusion

Ofgem's initial proposals correspond in many respects with the views we expressed in our response to the earlier consultation paper. There are a number of differences, for example the proposed use of fixed benchmarks, rather than the 20 year rolling historic average target that we proposed. Overall however the proposals form a reasonable basis for the future incentive.

There remain to be resolved a number of 'technicalities' - particularly around setting the benchmarks - which are vital to the success or otherwise of the proposed incentive. We would welcome the opportunity to contribute further to development work in this area.