Aquila Networks plc
Toll End Road
Tipton
WestMidlands
DY4 0HH

Telephone 0121 530 7572
Fax 0121 530 7573
andy.phelps@aquila-networks.co.uk
aquila-networks.co.uk

22 August 2003

Cemil Altin
Head of Price Control Review
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Our ref:AKP/SE

Dear Cemil,

Electricity Distribution Price Control Review (DPCR)

I am writing to provide Aquila's views in respect of Ofgem's (i) Electricity Distribution Price Control Review – Initial Consultation, July 2003, and (ii) Developing Network Monopoly Price Controls – Initial Conclusions, June 2003.

We are pleased to see within the main objectives that there exists a clear understanding of the key drivers for the next review. These are principally the need to invest, together with the incentives to deliver such investment, in order that companies are able to meet their obligations in respect of quality of supply, in the short and longer term, and environmental considerations, including Distributed Generation and network losses. This is at a time when customers' expectations are increasing in respect of the reliability and resilience of their electricity supplies and flexibility with which it can operate in order to accommodate a significant amount of new generation.

As well as the need to invest, the scope to continually make cost reductions is much reduced, as it is increasingly becoming more costly to seek out further efficiencies. We therefore need incentives to be strengthened in order to protect the long term interest of customers, by adopting an average cost approach to assessing efficiency, and extending the retention period of the rolling opex and capex mechanisms.

We are pleased to see the paper acknowledges the importance of companies being able to continue to access funds at reasonable cost, a precondition for investing in the network. We welcome the fact that Ofgem will base its assessment on the ability of companies to maintain financial ratios consistent with a credit rating that is "comfortably within the investment grade category" (in our view A to A-). Companies must therefore be allowed to generate sufficient cash to maintain

Aquila Networks plc. Registered Office:
Whittington Hall, Whittington, Worcester WR5 2RB
Registered in England & Wales No: 3600574

these ratios, which will allow them to raise the necessary funds to maintain the network and meet the expectations of their customers, both present and future.

However, in achieving this, Ofgem must fully acknowledge the issues that will have an adverse effect on the DNO's cash position. These include:

- the withdrawal by the Inland Revenue of the 'Non-load Agreement' which will have a significant increase on the amount of tax we will be expected to pay from 2005
- increased pension costs due to the reduction in expected returns from the stock market, and increased life expectancy
- end of pre-vesting depreciation across the industry and the subsequent impact on revenues

Another important aspect of our ability to raise the necessary finance will be the perceived risks and returns afforded to the Industry. It will therefore be essential to have a predictable approach in place to deal with uncertainty and risk. Interim determination and logging up mechanisms would be a useful addition to the regulatory framework for starting to address this issue. We look forward to working with you over the coming months to develop these arrangements for managing unforeseen or unquantifiable cost shocks to the business, particularly with regard to the huge uncertainty associated with the connection of Distributed Generation. We must also address the mechanism for dealing with exceptional events which is capable of meeting customers' expectations, whilst mitigating the risk to both equity and debt providers.

We look forward to discussing them further with you over the coming months but if, in the meantime, you have any questions then please do not hesitate to call.

Yours sincerely

Andy Phelps
<u>Regulation Director</u>

Detailed Comments

Our comments predominantly follow the structure of the July consultation. However where we have specifically covered issues raised in the June document, we have specifically highlighted this below.

1 "Form, Structure and Scope of price controls"

1.1 Scope of the price controls

1.1.1 Extra High Voltage (EHV) charges

Ofgem stresses the importance of setting out a regulatory framework that provides EHV customers with an appropriate level of protection from the abuse of monopoly power. We operate to a published EHV tariff that is calculated in the same manner as other regulated customers. Furthermore, we offer EHV customers the flexibility to negotiate site specific terms based on actual costs. Whilst customers should have an appropriate level of protection from the abuse of monopoly power, to regulate charges for EHV customers would remove this flexibility, which in our experience is valued by these customers.

1.1.2 Connection charges

Ofgem is considering the inclusion of non-contestable connection charges within the price control. Whilst connection charges provided under the Electricity Act or Licence are not directly regulated, they are subject to determination to protect customers' interests. At present the model of competition in connections, whereby distributors adopt assets, is voluntary and falls outside existing statutory and licence requirements. Any move to bring non-contestable charges into the price control will require formalisation within either the Electricity Act or the Licence.

Regulating non-contestable charges within the price control would represent the first time capex was treated in a similar way to opex. Care would need to be taken to ensure that there was no distortion in the treatment of costs between these charges and those of statutory connections that remain capex and are controlled by determination. In addition, since the overall level of non-contestable costs will vary depending on competitive market activity in each area, comparison of efficient costs would be difficult to achieve.

Ofgem has recognised within the Electricity Connections Steering Group that where a competitive market place exists, a distributor's overheads will need to rise to manage that market place. Whilst this may be offset by lower charges for the customer on contestable works, it is important that these additional costs are fully recognised to avoid the stranding of overhead costs.

The document also considers introducing standards of performance in certain areas. We consider there to be three fundamental principles that should be adopted in deciding such standards. They are:

- There should be no discrimination between the standards for competitive and statutory connections, to avoid the distortion of the market place

- The standards should be targeted to make them effective and practical to operate. They should not be out of proportion with other standards of service in terms of number or complexity.

- The standards should not artificially incentivise a distributor to put resource into new connections at the expense of existing customers (i.e. a distributor must have the ability to utilise resources on the system in times of emergencies without being penalised).

1.2 Improving the Incentive and price control framework

Ofgem summarises the initial conclusions set out in the June 2003 document on how the existing price control framework could be improved. This included the merits of incentive regulation under the RPI-X model, which we have supported.

RPI – X has provided incentives for companies to deliver statutory and licence obligations at least cost, and in the process has resulted in significant productivity gains and reductions in customer prices. Asset management techniques have advanced significantly since privatisation, which has enabled the life cycle of assets to increase, and therefore contributed to these improvements in efficiencies.

However it is clear that customer expectations have changed with regard to the underlying integrity and security of network assets. Whilst extending the life of assets through maintenance and repairs has been beneficial to customers, this cannot continue indefinitely without increasing the risk of asset failure. In support of our long term approach to asset management, the next price control should focus on developing incentives to encourage investment in the network. This is especially relevant given that our asset profile means we are approaching a period of high renewal and replacement as a result of the rural electrification of the 1950s and 1960s. We are concerned the incentives as they stand do not strike an appropriate balance between the interests of current and future customers. As discussed in our letter, this will require greater incentives to invest than presently, together with a more stable and certain framework for the longer term.

The way companies manage risk on their networks will be a key driver for investment in the next price control. Given that each company will have a different approach to managing risk, it will not be appropriate to adopt a generic approach for deriving capex projections. There is therefore a need to look at the longer term investment strategies of companies and their impact on future prices, with more weight placed on those companies who have demonstrated robust asset risk management (ARM) processes.

1.3 Dealing with uncertainty, new obligations and costs (Initial Conclusions June 2003)

Ofgem promote the use of a decision-making framework for developing policies for dealing with uncertainty both at reviews, and for considering how to address new costs arising between reviews. We support this and believe that more formal arrangements should be introduced to reduce risk for both equity and debt providers as applied in the Water Industry.

Where unforeseen or unquantifiable cost shocks affect the business mid-way through a price control, interim determinations and logging up mechanisms should be included to improve the flexibility of the price control framework. Where these costs fall outside the control of companies, they should be passed through to customers, which will assist in underpinning the credit worthiness of the business. However, we accept that where companies are able to control these costs, some form of incentive may be appropriate rather than pass through.

1.4 Incentives to invest (Initial Conclusions June 2003)

Under the existing price control, Ofgem project the level of capex for each company, but given the potential inaccuracy surrounding any forecast, the capex requirement may not be sufficient to deliver the level of service expected of our customers. Ofgem are considering mechanisms for increasing flexibility such that capex allowances are not necessarily viewed as an absolute maximum. In principle, this is a useful addition to the regulatory framework but there are a number of issues raised by the proposal.

Any spend above that forecast in DPCR 3 will initially be recompensed via the Information and Incentives Project (IIP). Such investment, if justified, must then be included in the Regulatory Asset Value (RAV) to earn the accepted rate of return. In order to provide DNOs with appropriate certainty, the criteria for inclusion must be clear and transparent. By only remunerating a proportion of the additional spending at below the allowed cost of capital, this will discourage distributors from investing above allowances, even where it is demanded by customers.

1.5 Distortion of incentives between opex and capex (Initial Conclusions June 2003)

Ofgem is committed to allowing companies to retain the benefits of efficiency savings for a fixed period of time for all costs, which we have supported. However it has rejected the suggestion that the proportion of the saving retained should be equal between opex and capex. One reason set out is that it is not possible to equalise the retention rate across different ‘types’ of efficiency savings. We accept that this is the case when comparing all four types of saving outlined in the document: one-off opex; permanent opex; one-off capex; and permanent capex. Nevertheless, where there is a clear trade-off between a permanent opex saving (such as lower repair and maintenance costs following the commissioning of an investment project) and a one-off capex saving (deferral of an investment project)

the incentives could be aligned. Ensuring that the proportion of the efficiency saving retained by a company is the same could be achieved by either setting different retention periods or by using a multiplier adjustment (proposed by Ofwat[1]) as set out in table 1 below.

Retention period opex	**Multiplier**	**Savings (permanent opex)**	**Retention period capex**	**Savings (one-off capex)**
5 years	1.31	38%	5 years	38%
7 years	1.00	38%		
5 years	1.69	49%	7 years	49%
10 years	1.00	49%		

Table 1 Retention periods and savings retained by shareholders

This means that either the retention period for opex would have to increase, or a multiplier in excess of 1 must be introduced to align the retention period with the duration of the price control. This would also increase incentives to make further savings to the benefit of future customers as discussed below.

The distortions that arise can be further mitigated by assessing efficiency on the basis of total costs. We therefore welcome Ofgem's intention to undertake further work over the coming months to develop thinking in this area.

1.6 Retention period for efficiency savings (Initial Conclusions June 2003)

Ofgem considers that the appropriate retention period for efficiency savings made during the existing price control is 5 years. We do not concur with this view. Efficiency savings are not costless, often requiring an initial investment. The net benefits of a cost saving scheme were initially high after privatisation as a result of the inherited inefficiencies. However, having removed these costs from the business, it is becoming harder and more costly to undertake and sustain further efficiency savings. This will reduce the net benefit of any future scheme, with the implication being that fewer cost saving projects will be viable without a greater share of the efficiency savings being allocated to shareholders. To maintain a consistent incentive to make improvements, we suggest a more equitable sharing of the benefits between customers and shareholders. If Ofgem wish to align the retention period with the duration of the price control, we would advocate a multiplier in excess of 1 (as explained above) to achieve this, and which ultimately deliver benefits to customers in the form of lower prices

With regards to introducing the rolling opex mechanism from April 2003, it seems perverse that the incremental benefits of making an additional saving in March provide 17% of the overall benefit to shareholders, whereas a comparable saving in the following month provides an additional 10% benefit. To overcome this issue (and we would still claim there was an expectation during the current price control),

[1] A further consultation on incentive mechanisms: rewarding future out-performance and handling under-performance of regulatory expectations, Ofwat, June 2003

the introduction of a rolling mechanism for operating costs should start from April 2001.

In respect of capex efficiencies, Ofgem is now minded not to put in place a mechanistic link between the achievement of these savings and the delivery of 2004/05 IIP performance targets (number and duration of interruptions). We support this decision, and believe that any rewards or penalties are explicitly captured by the IIP, which was introduced to counterbalance the cost reduction incentives of RPI-X.

2 "Quality of service and other outputs"

2.1 Form of the incentive scheme, targets and incentive rates

We welcome Ofgem's review of the Information and Incentives Project (IIP), and in particular the acknowledgement that the inclusion of planned interruptions provides perverse incentives to accelerate or delay network investment, especially where a company is close to its target. We also believe that customers' disruption through a planned interruption is significantly less than that caused by a fault, especially since customers are notified well in advance, and interruptions are generally timed during low periods of demand. Consequently, planned interruptions should be separated out from those of other interruptions, and in our view be subject to no penalty.

2.2 Development of the Guaranteed and Overall Standards of Performance (GOSPs)

In the document, Ofgem is considering for the next review the scope and level of GOSPs and payment for failure. Guaranteed standards provide a useful means of recognising a failure to deliver minimum standards to customers.

The financial consequences of having no access to electricity for customers operating in certain market sectors nevertheless is potentially significant. This is recognised by distributors bearing no liability for consequential loss under the Electricity Act. Indeed it is common for larger demand customers to invest in higher security connections, where they recognise a need for a more robust supply. Our view is that the present level of payment is sufficient and we would not support an increase in the magnitude, since this would materially increase the risk to the business, which would otherwise have to be reflected in the cost of capital.

Ofgem has also set out its intention to re-evaluate the likely costs and benefits of introducing automatic payments under GS 2 (the 18 hour restoration period standard). This will require the establishment of phase connectivity to ensure we know specifically which customers have been affected by a particular fault. This we continue to believe, is prohibitive in terms of costs. Furthermore we are aware that some distributors do not even have actual LV connectivity. Therefore we do not believe the industry is in a position to make automatic payments for Guaranteed Standards with any degree of accuracy or certainty.

The scope of the customer research should inform what customers ascribe as the key outputs of the distribution business. Any tightening of Overall and Guaranteed Standards will increase the cost to the business, and should only be undertaken if appropriately financed and consistent with customers' willingness to pay.

The review will also consider whether it is appropriate to include some of the Overall Standards in the IIP incentive scheme. We would not support such a move where the outputs are already captured by the scheme. Given that the IIP process is also relatively new and is only just starting to be bedded down, it seems an inappropriate time to consider changing the framework. Any new measures will increase the complexity of the incentive regime, perhaps even creating unnecessary tensions between outputs. Therefore any expansion will need to be considered very carefully, and may also require new measurement systems to record levels of accuracy consistent with those required for the IIP audit.

2.3 The treatment of exceptional events

The document seeks to address the weaknesses of the current exemption regime, in particular the:

- lack of clarity of incentives on distributors
- separate exemption mechanisms for IIP and Guaranteed Standards
- delays and confusion for customers
- resources required of Ofgem and energywatch

We look forward to engaging with Ofgem to resolve these issues for the next price control.

In the meantime, Ofgem propose a set of interim arrangements to address some of these problems, not least those encountered as a result of the October 2002 storms. We would in principle support proposals whereby distributors would pay out all valid claims to customers for interruptions exceeding a given duration, and then seek to recover the costs from all customers. However, it is important that the criteria used to ascertain the proportion of cost recovery from all customers is objective and hence clearly defined and understood.

Whilst accepting that companies should be required to take practicable steps to restore supplies and should have incentives for doing so, using a simplistic high-level benchmark is not acceptable to ascertain what reasonable restoration times are. It is accepted in other aspects of the regulatory framework that performance is not comparable between companies. Furthermore, a benchmarking approach creates a competitive regime between distributors, which is contrary to the collaborative NEWSAC arrangements for assisting each other in emergencies. We therefore expect a company specific approach to be taken, which reflects the allowances and incentives in place to deal with such events, and hence is a realistic test of 'reasonableness'.

Also, any pass through must be resolved in the year in question and cannot be allowed to be rolled up into the general price control debate. This creates a further

degree of subjectivity which is unacceptable. Finally, we would not be prepared to accept a framework which abandons Force Majeure entirely and therefore exposing us to, in effect, unlimited risk.

2.4 Consumer research

The consultants appointed by Ofgem to undertake phase two of the consumer research intend to use stated preference techniques. We support this methodology for inferring consumers' willingness to pay for improvements to key outputs identified in the first stage of the consumer research, in the light of the cost information provided by distributors in the forecast Business Plan Questionnaire (BPQ).

A paper submitted by the EA last year suggested that "choice experiments" is the most effective stated preference methodology for eliciting customer preferences. We recommend that this approach be adopted for the review. We envisage that the results of the second survey be used to inform whether the scope and level of performance of the IIP should be extended. However by implication, extending the scope and revenue exposure under the IIP would increase risk and hence the cost of capital for distributors. Furthermore any additional outputs that are financially incentivised will need to be capable of being measured and audited with the same degree of accuracy as those used for the existing regime.

In terms of setting targets, the customer survey will only represent one aspect of the equation. It is also important to understand the marginal costs of delivering performance improvements within each company in order to conclude on appropriate targets for the next review and beyond.

2.5 Rewarding frontier performance (with regards to the IIP)

In the document, Ofgem reaffirm their commitment to reward frontier performance in terms of quality of supply for the IIP. Whilst Ofgem would like wherever possible to define frontier performance based on comparison across companies, we do not accept that the normalisation required to achieve this is statistically robust.

We have however been a major contributor in trying to understand the key drivers of performance through Ofgem's Performance Disaggregation Working Group, and identify potential areas for network improvement. This work should help to inform the setting of equally challenging targets for distributors, but it is by no means a process for delivering normalisation and hence identifying frontier performance.

We would therefore expect Ofgem to define frontier performance as being the rate of improvement in quality since the audited IIP performance scores in 2001/02. Companies who are in the upper quartile range could be rewarded either via a financial reward or by being set targets requiring lower rates of improvement. Through appropriate calibration, an ex-post financial reward could be set equal to the cost saving of meeting slightly easier targets. However if longer term targets for quality are envisaged, with an appropriate glidepath and capital allowance to

reach this level, it may be preferable to provide a financial reward for frontier performance.

2.6 Incentives for the speed and quality of telephone response

In the document, Ofgem is giving further consideration as to whether financial incentives should be introduced for the speed of telephone response. At present there are a number of significant inconsistencies between distributors in their measurement of this output, which would prohibit a financial incentive being introduced. This is acknowledged by Ofgem who have published a separate consultation paper on the subject.

If financial incentives are to be introduced, we would not support a comparative regime as it would encourage distributors to spend finite resource on improving speed of answer to a level that far exceeds customers' willingness to pay. There is also a real danger that integrated companies, or those with multiple licences will have greater resources available, distorting the results. During Business Separation, Ofgem were particularly opposed to us using npower as a regular overflow in handling such calls. To remove this perversity, we believe any financial incentive should be related to delivering a threshold target, which could be dictated by the results of the customer survey.

Ofgem is also giving further thought on whether to extend the components of the survey that make up the quality of telephone response incentive. We have had significant concerns over the robustness of this customer survey, and have raised these with Ofgem on numerous occasions. It is far from appropriate to consider extending the scope of the survey until these concerns have been sufficiently addressed. In respect of the suggestion of including speed of response within the survey, this should not be undertaken if it is already separately incentivised within the IIP, otherwise distributors face the prospect of being penalised or rewarded twice.

3 "Distributed Generation"

3.1 Incentives for network access and investment

The document considers how incentives can be designed for distributors to provide access to generators to connect to the network. After reviewing a number of options, Ofgem propose a hybrid approach, which provides pass through of costs into a Regulatory Asset Value (RAV) plus a £/MW revenue driver. In principle we would support such an approach. However for this to operate, we need certainty over the criteria for determining pass through. Furthermore, a number of practical issues need to resolved, not least whether costs will be passed through into a generator or demand RAV, and the implications of either approach.

We do not believe that the pass through of reinforcement costs for connecting generators to the network should be remunerated at less than the allowed cost of capital. Whilst the additional payment from the revenue driver may provide a

premium rate of return initially from a generator connecting, distributors would ultimately be penalised if a generator subsequently disconnected on commercial grounds. To therefore encourage investment, and ensure the government's environmental agenda is met, the mechanism needs to ensure that a distributor cannot earn less than the average cost of capital, even if a generator subsequently disconnects.

The document also discusses whether a network availability measure can be established and utilised in practice, such as multiplying DG capacity by the amount of time access is available. There are a number of reasons why we would not support this.

- As well as access being difficult to measure, we believe it inhibits distributors offering lower cost connection with lower security. In our experience this is what most generators want and to disincentivise distributors to offer this option would represent a barrier against connecting generation

- An incentive designed to benefit one customer group (i.e. generators) would be discriminatory against other customer groups who may be exposed to higher economic losses than generators

- Investment to provide access to generators is generally capacity driven, and so a MWh driver would expose distributors to risk in the generation market. In times of low settlement prices, generators are likely to follow each other and reduce units exported onto the distribution network, thus exposing distributors to higher risk

3.2 Cross subsidy of distributed generation costs

We note with interest that some distributors have put forward a proposal for a levy on all consumers across Great Britain, which could then be redirected to those areas where DG connection and/or costs are highest. Whilst we believe our customers are more likely to support increased prices to fund improvements in network security and reliability of supplies rather than to aid the connection of DG in another part of Great Britain, these conflicts of priority should be explored within the customer survey. Such an arrangement may also perversely incentivise DG connection ahead of more appropriate projects.

4 "Assessing costs"

4.1 Use of bottom up modelling

In the document, Ofgem has set out its intention to use bottom up modelling in areas such as load and non-load related capex, fault expenditure and repair and maintenance. For a sensible comparison of performance to be derived to gauge efficiency, the analysis must be undertaken on a consistent basis between companies.

We have a number of key concerns, and which impose limitations on such simple bottom-up benchmarking:

- Analysis will not be robust nor encapsulate all the costs. Companies define these activities differently and allocate costs to varying extents using different bases. E.g. are Group, property, facilities, IT&T etc. costs allocated consistently across such a narrow band of activities? Many of these problems with DPCR 3 are now recognised and will not be resolved by simply disaggregating the activities further. We therefore caution against placing too much reliance on such analysis, particularly as the drivers for such costs may differ significantly between companies.

- Inappropriate 'cherry picking' of the lowest unit cost items in each category (where there are inevitable differences in cost allocation between categories) leading to an artificially low cost benchmark.

- Economies of scale and apportionment of fixed costs will be realised from mergers. Without an appropriate adjustment, this would discriminate against non-merged distributors.

4.2 Use of top down modelling

Ofgem places considerable reliance in comparing the costs of distributors, and has recognised that the management of a company is an important determinant in assessing efficiency. We support Ofgem's intention to compare costs on the basis of both 14 licensed companies, and 8 independent management teams. Companies that have not merged should not be penalised in the comparative efficiency analysis, and we believe that this will go some way to achieving this outcome. Nevertheless, it is important that Ofgem takes proper account of the unavoidable, fixed costs for non-merged distributors in both the operating and capital cost benchmarking process. However, it is unlikely that any one comparison will be statistically robust and capable of incorporating all variables. We therefore expect Ofgem to draw on a number of such models in order to draw overall conclusions of relative efficiency.

It is our belief that the assessment of efficiency should not be made solely on the basis of operating costs. We therefore support Ogem's intention to use total costs as one of a number of approaches for top down modelling. Furthermore we welcome the appointment of Cambridge Economic Policy Associates (CEPA) for assessing the approach taken to the opex regression analysis at the last review, and for identifying improvements for the forthcoming review. It is our expectation that by coming to a common view on the shortcomings of the approaches used in DPCR 3, Ofgem and the industry can agree on a more robust approach to efficiency assessment for DPCR 4. In order for this to be effective, it will be important for the findings of the CEPA study to be shared with the industry and for there to be transparency on the overall framework and specific techniques to be applied in DPCR 4.

The analysis of cost drivers is just as important in the assessment of efficiency. At the last review, the explanatory variable included customer numbers, line length and units distributed. In our view, the Business Plan Questionnaire should be used to inform debate on the relevant drivers to enable meaningful comparison of costs, and adjust for unique factors affecting a distribution business. Particularly with the separation of metering at the next price review, we now expect the Network to be the sole driver of such costs.

The assessment of efficiency, however, should not include quality of supply. As is now recognised, the industry is still a long way off from being able to define all the factors that drive network performance and hence be in a position to fully adjust performance to realistically compare companies. Whilst the disaggregation of quality of supply, in conjunction with the results of second stage of the customer survey, provides an understanding for setting realistic targets for improvement, it is not a mechanism for simply inferring relative performance. The Frontier Economics report on incentives also supports the separate incentivisation of quality outside of the efficiency analysis.

4.3 Use of average rather than frontier costs

The document discusses the approach to assessing costs, in respect of top down modelling. Whilst this is important, the debate on incentives also needs to set out whether efficiency and hence forward looking costs will be set on the basis of the average or frontier company.

The Frontier Economics report put forward proposals that would project costs on the basis of the average company, which has higher incentive properties compared with a frontier driven approach. This mechanism replicates the operation of competitive markets whereby the most efficient companies earn higher than average rates of return, whilst below average companies earn lower than average rates of return. Companies will have strong incentives to make efficiencies as soon as they arise, since any delay will only have a negligible impact on future allowances. This also helps to increase the benefits of making efficiency savings at a time when the costs of realising these are increasing, as we set out in the section on retention periods.

4.4 Use of total factor productivity (TFP)

Ofgem is appointing consultants to undertake work on assessing total factor productivity, to ascertain whether costs can continue to fall in the future. Whilst we believe that this is a sensible approach to take, it is important not to place too much reliance on past productivity improvements for informing estimates for DPCR 4. For example, companies had large scope to remove inefficiencies at privatisation, but this process has now been completed, which unless taken account of, will inflate the potential for further cost cutting.

We support the use of TFP for forecasting the shift in average costs over the next price control. However we would fundamentally disagree with implementing TFP on top of a frontier driven approach to costs. Whilst an assessment of TFP is

based on average performance, applying this to frontier companies would represent unrealistic expectations, and a significant tightening of the regulatory framework.

It is our view that since the inefficiencies inherited at privatisation have been removed from the distribution business, forward looking productivity is unlikely to diverge from the general economy, which is largely captured by RPI. This would imply that any downward shift in average costs would be minimal over the next price control. Indeed there are a number of pressures, which could actually increase costs such as Lane Rentals, ESQC Regulations, wayleaves, and possible wider congestion charging.

4.5 Use of the asset risk management (ARM) survey

Ofgem intends to update the ARM survey during 2003/04, focusing on improving the understanding of distributors capex forecasts, and developing a better understanding of the approach to asset management. In our opinion, the ARM survey should be used to test the credibility of the capex submissions made by distributors. Where a distributor has demonstrated a robust ARM process, Ofgem should place more weight on the company's own strategies and forecast information.

5 "Financial Issues"

5.1 Obligations and duties with respect to the financing of companies (Initial Conclusions June 2003)

Whilst Ofgem considers that its approach to the financing duties and obligations are appropriate, it will review whether the financial ring-fence needs to be strengthened.

A fundamental requirement of the DPCR4 settlement will be that it finances the investment required for companies to discharge their obligations (primarily derived from security of supply and environmental objectives). There is real concern throughout both the industry and the City regarding the current investment climate, which must cast serious doubt over the ability of companies to secure the required levels of investment going forward. Clearly, providing sufficient incentives through appropriate rates of return will be a key driver.

Ofgem states the importance of companies being able to continue to access funds at reasonable cost and that it will base its assessment on the ability of companies to maintain financial ratios consistent with a credit rating that is "comfortably within the investment grade category". In our experience, key factors taken into account by the ratings agencies include levels of interest cover and free funds. It will therefore be important that companies are allowed to generate sufficient cashflow to maintain ratios consistent with a "comfortable" credit rating (in our view A to A-), which will also provide flexibility and a buffer against exogenous factors.

Whilst we acknowledge that effective financial ring-fencing is supportive of investment and safeguards the interests of consumers, investors and the licensee, we do not see any compelling evidence for wholesale strengthening of the ring-fence provisions within companies' licences. The current ring-fence provisions have proved to be a sufficiently robust legal framework, evidenced by our own recent experience.

Ofgem supports the introduction of a special administration regime in the event of a financial failure of a network operator. This provides a 'safety net' for consumers, and we believe further mitigates against the need to strengthen the existing ring-fence. However, as emphasised in the Electricity Association's (EA) response to the DTI consultation paper (June 2003), it is important that this regime does not inadvertently weaken the ring-fence and subsequently increase market perceptions of regulatory risk. Accordingly, a special administrator should only be appointed as a last resort, in the event of insolvency having occurred. Due regard must also be given to the interests of creditors (e.g. transfer of both assets and liabilities, or 'fair value' given for assets transferred).

In order to minimise the possibility of insolvency occurring, the EA also advocated a licence condition for pass-through of 'cost shocks' beyond the licensee's reasonable control (something similar to licences within the water sector). We believe that this would further underpin a licensee's creditworthiness.

5.2 The cost of capital

5.2.1 The treatment of tax costs (Initial Conclusions, June 2003)

We welcome Ofgem's commitment to review the expected tax position of each distributor as part of the financial modelling. In accepting the DPCR 3 proposals, we accepted a package on the basis that there were opportunities to outperform. Taxation was one such area.

The new tax treatment of non-load related capital expenditure from April 2005 will lead to a significant increase in the effective tax rate of our business. Ofgem has argued that tax should be treated like any other cost. We agree and accept that any efficiencies deriving from tax should be shared between customers and shareholders after a suitable period. Moreover we would expect the incremental increase in tax liabilities to be recovered within the price control. This could be achieved by setting company specific tax allowances, bringing certainty in terms of recovery of costs, whilst providing opportunities for outperformance. Such a policy is already adopted by Ofwat who treat expected tax liabilities of each company as a cost to the licence business. However any failure to compensate for the increased tax liability will create a material impact on our ability to finance the business and any new investment.

5.2.2 Embedded debt

Ofgem argues that in view of the relatively stable trends in real interest rates, there is no requirement to provide an additional allowance to reflect historic debt.

However we believe that it remains appropriate for Ofgem to allow distributors to recover the costs of fixed rate long term debt where this is part of a historic efficient financing portfolio. We therefore welcome Ofgem's willingness to consider specific points made by companies on this issue, and look forward to discussing these with you in the near future.

5.3 Assessing the RAV and the approach to depreciation

Ofgem discusses the depreciation issue facing most distributors in the next price control, namely that pre-Vesting assets will be fully depreciated (December 2005 for Aquila) leading to a sharp fall in allowed revenue. We have undertaken some modelling which suggests that the financing problem generated by this effect is only short lived, mainly throughout the DPCR 4 period. This is because the investment levels of the business will be significantly above depreciation, but over time, the depreciation profile will once again follow an upward trend until long run equilibrium with capex is reached. A significant increase in replacement capex will accentuate the impact caused by the depreciation cliff face.

The document considers whether this should be addressed by changing the depreciation profile from 33 to 20 years, as applied to three distributors in DPCR 3, or whether there are any alternative proposals such as funding a proportion of replacement capex in the year incurred. A downside to either approach is the rapidly eroding Regulatory Asset Values (RAV) and thereby levels of regulatory return and depreciation. Furthermore, full or partial expensing of replacement expenditure without appropriate incentive arrangements including contingency allowances provides no opportunity for distributors to earn a return. Consequently, as the problem appears to be short-lived, any proposal should attempt to avoid creating a longer-term negative impact upon the business.

5.4 Treatment of pension fund costs

The publication of Ofgem's proposed guidelines for dealing with pension costs is a very positive step forward and we are generally supportive of many of the main issues. We accept that the benchmarking of employment costs will play a key role in Ofgem's assessment of efficiency.

In any benchmarking exercise, Ofgem must:-

- appreciate that pension is only one aspect of a total employment package;

- take full consideration of the implications of the Protected Persons Regulations and the no detriment rule, both of which were introduced prior to privatisation;

- undertake the exercise in a clear and transparent manner.

However, regarding any deficit, it is unclear what income was provided for pension contributions in the current price control. Most distributors were on a pension holiday and consequently, since any allowance was provided on the basis of two

Aquila Networks plc. Registered Office:
Whittington Hall, Whittington, Worcester WR5 2RB
Registered in England & Wales No: 3600574

‘efficient’ companies, we doubt the inclusion of any pension funding implicit within our operating cost allowance.

Ofgem’s proposals also state that “liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account”. However, in common with most (if not all) merger and acquisitions in the electricity industry, when Midland Electricity disposed of its supply and retail businesses, this did not include the transfer of the pensioners. Also, Midland Electricity operates a number of unregulated businesses (e.g. Metering and Contracting). Where these undertake work outside of the distribution business, we agree that the funding of this proportion of their pension costs should not be borne by the Distribution business. However, any deficit as a result of past regulated employment is a result of under-funding, in hindsight, by customers in the past. This deficit should therefore be made up by the current customers within future distribution price controls.

Ofgem also suggest that companies will be expected to absorb any increase in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions. We would like to seek additional clarification of the term ‘enhanced pension benefits’. We have made use of a surplus within the Midland Electricity scheme to encourage severance, but only to the extent required by the scheme rules (the majority of payments have been made to ESPS members and hence the rules are covered by the Protected Persons Regulations). There has been no element of enhanced benefits. However, on a point of principle, the use of this severance has enabled Aquila and other distributors to reduce their operating costs to levels below those envisaged. We should not be penalised for seeking to increase efficiency through these means, which has ultimately been reflected in lower prices to customers.