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Mr Chris Chapman
Head of Planning
Ofgem
9 Millbank
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Dear Chris,

Ofgem's three year strategy 2004-7

I refer to the letter dated 1 September 2003 sent to Don Bacon, our Chief Executive, and myself inviting our views on Ofgem's future strategy for 2004 – 7. Don has asked me to respond on the company's behalf.

Ofgem will appreciate that the distribution sector of the electricity industry is at a watershed, facing several important issues that will shape its future direction. These are:

- Investment, storm resilience and long-term network integrity
- Environmental (e.g. Distributed Generation)
- Competition in new connections and metering

We look to Ofgem to fully address our concerns in respect of these issues in its forthcoming three-year strategy, and, crucially, within the scope of the current Distribution Price Control Review (DPCR).

Whilst we believe that it is necessary to identify the short and medium term challenges which confront the electricity industry, it is important that Ofgem takes a long-term view. This will facilitate stability, a pre-requisite for an industry with long investment timeframes, which will enable companies to ensure the future dependability of distribution networks through effective forward planning and the ability to raise the necessary finance. We would therefore wish to see Ofgem set priorities for the next three years against the backdrop of such a longer-term strategy. This would be entirely consistent with the objectives of the Energy White Paper and Ofgem's principal objective of protecting both existing and future consumers' interests.

We also believe that it is essential for Ofgem's strategy to be underpinned by a process that is consistent with the recognised principles of good regulation. It is important that any significant change to the regulatory framework is only introduced after full consultation and the resolution of all material issues. We believe that Ofgem has recently fallen short of best practice in some instances, particularly in the process by which competition has been introduced into new connections and metering markets. We do not believe that the case for its introduction has ever been adequately made, indeed the lack of a robust process has in our view actually hindered the development of competition.

We are therefore pleased that Ofgem has committed to Regulatory Impact Assessments for all new major policy initiatives. Our experience of DPCR4 to date has also been encouraging, as Ofgem has demonstrated a willingness to engage with the industry and openly debate the many complex issues involved. We look forward to Ofgem continuing to demonstrate its commitment to providing a transparent, accountable and stable regulatory framework. This will minimise regulatory uncertainty and facilitate the timely and efficient delivery of policy objectives.

Please find below our thoughts on areas on which you particularly requested our comments:

Key challenges facing the industry in the short to medium term (for example, structural, social, environmental or technological)

The long-term integrity of networks, and their resilience to severe weather events are of paramount importance, both socially and economically. This is undoubtedly the most significant challenge for Distribution Network Operators (DNOs) faced with an ageing asset base. The storms of October 2002 and supply interruptions more recently, have demonstrated the extent of political and public concern, and the high level of customer expectation with respect to supply continuity. Resolving these issues will only be achievable by continuing to invest adequately and efficiently in the network. To enable this it is vital that investors are given sufficient incentives to invest for the long-term, if the industry is to contribute to meeting Government goals for reliable energy supplies, and the demands of the public.

Environmental issues are also currently a high priority, and we support the work Ofgem has undertaken in order to explore how best to support and encourage growth in Distributed Generation (DG). Ofgem must ensure that DNOs do not bear undue financial risks as a result of any new policies adopted to assist expected growth in DG, and that the businesses are appropriately incentivised to do so. Another important environmental challenge is reducing network losses. It is important to recognise the distinction between technical and non-technical losses. The current incentive has not been sufficiently strong for DNOs to invest to reduce technical losses, in contrast to the incentives for mitigating non-technical losses (encouraging for example, efforts to improve unmetered supplies inventories, the registrations process and reducing illegal abstraction). We welcome Ofgem's revised proposals incentivising DNOs to reduce losses on their systems, however it

is important that the tension between the losses incentive and other incentives for opex and capex are balanced, to avoid creating distortions within the overall regulatory framework.

The further opening up of competition in metering and in new connections present potentially significant risks and difficulties for distribution businesses, yet to be fully addressed. In particular, DNOs must be protected from stranded costs that were efficiently incurred whilst fulfilling their licence obligations with respect to metering, and any potential distortion of the market between them and new entrants. Whilst we are committed to facilitating competition in connections, this is on the basis of DNOs not being exposed to additional risks and liabilities. To this end, it has not been helpful that Ofgem's approach to introducing competition into these areas has been rather ad-hoc, lacking in structure and due process. Indeed the lack of an appropriate legislative and regulatory framework (within which obligations and the associated risks may be fully accommodated) to support the development of competition, has impeded its development.

Other challenges facing distribution companies arise from a lack of certainty in some areas yet to be resolved, and this potentially increases risk with regard to the cost of financing the businesses. These include risks and costs arising from, for example, supplier credit cover, the Electricity Safety Quality and Continuity Regulations, the customer transfer project and lane rentals.

What action should the Authority take to respond to these challenges?

Most of the challenges outlined above should be dealt with, at least in part, through a transparent, robust and equitable Price Control settlement. We believe that Ofgem should make the long-term future of electricity networks its priority. Incentives must therefore be sufficient to encourage the necessary network investment and performance improvements, and to aid the achievement of environmental objectives. Incentives must also be appropriate, and thus take into consideration the differing capabilities and characteristics of the regional networks. DNOs must also be allowed an appropriate Rate of Return, and to generate sufficient cash to maintain financial ratios consistent with a 'comfortable' investment grade credit rating. Suitable mechanisms for dealing with the risk and uncertainties arising (including unexpected cost shocks) must also be in place to ensure a stable regulatory environment that is consistent with a low risk regulatory business such as electricity distribution.

In general terms, and outside the DPCR, early and decisive resolution of issues of concern to distributors (such as those listed above) will also help reduce regulatory uncertainty. There is we believe, a clear need for Ofgem to prioritise better and make decisions in a more timely fashion on issues which are of significance to DNOs - the treatment of Enron's bad debt being just one example.

I hope you will find these comments useful, and we look forward to working with Ofgem on meeting these challenges in the future. If you have any queries on the points raised, please do not hesitate to contact me.

Yours sincerely

Andy Phelps
Regulation Director

