



SP Transmission & Distribution

Response to Ofgem Consultation Paper:

Electricity Distribution Price Control Review Policy Document – March 2004

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EXECUTIVE SUMMARY

This distribution price control review is reaching a critical stage with initial proposals due for publication in June 2004. Our previous consultation responses have emphasised that this price review is different from previous reviews. Increasing costs in a number of areas, including distributed generation and network investment, will result in upward pressure on prices. Ofgem must take proper account of these differences when developing its proposals for the price review outcome.

The key issues are as follows:

- a sufficient and stable return is required to attract and retain equity funding;
- a forward looking framework is required to fund network investment associated with distributed generation and ensure that Government targets on renewable energy can be met;
- allowed investment must be increased to secure the long-term safety, reliability and sustainability of the electricity infrastructure;
- a sound and transparent approach to efficiency analysis is required to ensure adequate funding; and
- expenditure during the current price control period on post-fault asset replacement is capital expenditure that must be included in the RAV.

These issues are addressed in more detail below.

COST OF CAPITAL

An increased cost of capital is strongly supported by market evidence, recent regulatory determinations and authoritative academic studies.

- Investment confidence will be undermined if the cost of capital is set ‘too low’.
- The top-end of Ofgem’s indicative range should be extended by additional allowances for embedded debt and for debt issuance costs.
- The allowed figure should be towards the top-end of this extended range.
- The strongest incentives for tax efficiency and stability will be achieved through setting tax allowances based on the industry average position.

DISTRIBUTED GENERATION (DG)

Progress has been made towards the development of acceptable proposals however there are aspects of Ofgem’s proposals that will undermine incentives to connect DG.

- A ‘floor’ on the overall return on DG investment equal to the cost of debt does not provide sufficient protection in the event of forecast levels of generation not being achieved or sustained.
- Network availability incentives could undermine incentives to connect and should not be contemplated until further experience is gained of the operation of networks with high volumes of generation and until appropriate connection standards have been developed.
- We continue to believe that there are many instances where the most effective and efficient means of facilitating DG will be to carry out advanced deep reinforcement and we urge Ofgem to reconsider the treatment of such investment.



NETWORK INVESTMENT REQUIREMENTS

Allowed investment levels must be increased to secure the long-term safety, reliability and sustainability of the electricity infrastructure.

- Investment plans presented in our Forecast Business Plan Questionnaires (FBPQs) are the next stage of longer-term plans to maintain network performance, safety and reliability for our customers in the SP Distribution and SP Manweb areas.
- These plans, focussed on critical assets, are the output of robust and detailed Asset Risk Management processes and will require the commitment and support of Ofgem over the next three price control periods.

ASSESSING COSTS AND EFFICIENCY

Ofgem's analysis must take account of data imperfections and of the very limited scope for future efficiency.

- An average rather than a frontier approach is most appropriate because of data consistency problems and comparability issues between companies.
- Analysis that is highly sensitive to different assumptions/data will not be robust enough to be used to set allowances.
- Simplistic analysis of past cost-trends would result in serious misrepresentation of the future potential for cost reductions.

TREATMENT AND FUNDING OF FAULT-RELATED EXPENDITURE

Our research and analysis suggest that fault-related replacement expenditure has not been adequately funded in the current price control.

- We agree with the principle that customers should not pay twice for any service but would emphasise that all properly incurred expenditure must be funded.
- Expenditure during the current price control period on post-fault asset replacement is capital expenditure that must be included in the RAV.
- We urge Ofgem to confirm this position as a matter of priority or to provide evidence to support any position to the contrary.

We look forward to publication of Ofgem's latest thinking on these issues, and on the many other important issues for this price review, in the June initial proposals. We remain committed to working with Ofgem and the rest of the industry to deliver a successful price review outcome that balances the interests of customers, shareholders and all other stakeholders. We hope that our comments in this response document will prove helpful in meeting this objective.



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SECTION 1: TIMETABLE AND CONSULTATION PROCESS

- 1.1 The distribution price control review is reaching a critical stage with the publication of initial proposals scheduled for the end of June. Much remains to be done and it is extremely important that companies and Ofgem continue to work together through the various working groups and via one to one meetings to enable the production of robust final proposals within the available timescales.
- 1.2 Transparency of outcome is vital. Companies must have access to the findings of Ofgem's analysis and to reports from the various visits at the earliest opportunity. This is essential in order to provide companies with sufficient time to consider this information, correct any inaccuracies or misunderstandings and respond to Ofgem before it is made public or initial proposals are produced. In addition, companies must have access to the various models used by Ofgem, including the financial model and the capex and opex models, populated with the data used to determine the initial and final proposals. This is essential to enable companies to understand and replicate the results of Ofgem's modelling.
- 1.3 Our previous consultation responses have referred to the need for a review of the price review process. We continue to believe that it is not appropriate for Ofgem to review its own process. An independent body reporting to the Authority should conduct this review, informed by comments from all interested parties, including Ofgem. This will ensure that all stakeholders obtain maximum benefit from this exercise.

SECTION 2 - FORM, STRUCTURE AND SCOPE OF THE PRICE CONTROLS

2.1 REVENUE DRIVER

2.1.1 We note Ofgem's proposals to retain the broad form of the revenue driver so that it is weighted equally between units distributed and the number of customers, subject to the following:

- the use of actual customer numbers as defined in the RIGs (Regulatory Instructions and Guidance); and
- a review of the weightings applying to the various voltage categories within the units distributed revenue driver.

2.1.2 We agree with the proposal to use actual customer numbers. As regards the weighting applying to the various voltage categories within the units distributed driver, we can see some attraction in looking at average DUoS Charges for each tariff basket component as an initial basis for discussion. This should not be confined to the 'volume' charges, but should include other charges as well. However, given that EHV charges are not unit driven and that charges in respect of new EHV connections will be treated as excluded services, we consider that the revenue driver for existing EHV connections should be set to zero. This will ensure that reductions in EHV units do not impact overall price-controlled revenue.

2.2 PRICE INDEX

2.2.1 We note that consideration is being given to whether or not the Consumer Price Index (CPI) should replace the Retail Price Index (RPI) for price control purposes. The rationale provided for a potential change is that the Treasury has changed the inflation target that should be used by the Monetary Policy Committee of the Bank of England from RPI to CPI.



2.2.2 A change to CPI for price control purposes is not appropriate for the following reasons:

- it would be inconsistent with the use of RPI elsewhere in the regulatory framework, notably the weighted average cost of capital;
- HM Treasury¹ has confirmed that that RPI will continue to be used as a measure of inflation;
- the relevance of CPI has been questioned by the Office of National Statistics;
- the Government's previous inflation target was based on RPIX (which excludes mortgage interest payments) whereas the price control has always been based on the all items RPI, hence the change in the inflation target is not relevant; and
- the RPI continues to be consistently used across other utility sectors as the basis of price controls.

These issues are dealt with in the following paragraphs:

Consistency

2.2.3 Introducing the CPI into the price control formula would be inconsistent with the basis on which the allowed cost of capital is set. The risk free rate component of the cost of capital, as measured by the return on index-linked gilts, is based on the all-items RPI.

RPI is the most widely used measure of inflation

2.2.4 RPI will remain the most widely used measure of inflation and should therefore continue to be used to provide protection against changes in inflation. The Government has confirmed that benefits, index-linked gilts, tax credits and tax allowances will continue to be indexed to RPI or its derivative indices.

¹ HM Treasury (2003) "The new inflation target", Annex to letter from the Chancellor of the Exchequer to the Governor of the Bank of England, December 10th

Relevance of CPI

2.2.5 There is a significant question about the relevance and credibility of CPI. We are in agreement with the conclusion of the Office of National Statistics² that:

“ the familiarity and credibility of RPI and RPIX based on their longer history is a key advantage. Inevitably, it will be some time before the CPI measure becomes as widely recognised. In addition, the CPI’s exclusion of most elements of owner-occupier housing costs is an outstanding issue, and lessens its relevance for some users.”

RPI and RPIX

2.2.6 The change in the Government’s inflation target is not relevant to the price control formula. The price control formula has always been based on the all items RPI whereas the Government’s previous inflation target was based on RPIX (which excludes mortgage interest payments).

RPI is consistently used across other utility sectors

2.2.7 The RPI is consistently used across other utility sectors as the basis for price controls. In particular, Ofwat proposes³ to continue to set the price control for the water and sewerage companies on the basis of RPI. There is a clear advantage in using the same price index across regulated industries, as it then provides a common basis for price controls. This facilitates understanding by customers and other stakeholders.

2.3 NGC EXIT CHARGES

2.3.1 We support the proposals not to change the treatment of transmission exit charges. As stated in previous consultation responses, these charges are non-controllable costs from the perspective of a distribution business and, as such, are not suitable for the application of an incentive regime, however limited.

² Roe, David and Fenwick, David (2004) “The new inflation target: the statistical perspective”, Economic Trends, January



2.4 WHEELING CHARGES

2.4.1 We support the proposal to correct a significant anomaly in the current regulatory regime by allowing charges for energy ‘wheeled’ across the network of another distribution company to be treated as full pass-through. In addition to annual charges, capital charges levied by other distribution companies in respect of wheeling should also be treated as pass-through. As stated in previous consultation responses, this treatment should also be applied to the wheeling costs incurred during the current price control.

2.5 EHV CHARGES

2.5.1 We continue to believe that there is no reason to change the treatment of EHV charges and that customers’ interests will be best protected by the continued treatment of EHV charges as excluded from the price control. However, we note Ofgem’s proposals to include these charges in the price control and we could support these proposals providing that an appropriate revenue driver, as detailed in 2.1.2, is agreed.

2.6 NON-CONTESTABLE CONNECTION CHARGES

2.6.1 We support Ofgem’s proposal that non-contestable connection charges will not be included in the price control. As stated in previous consultation responses, we are committed to the satisfactory introduction of competition in connections and believe that its development, and the interests of customers in general, will be best served by continuation of the existing arrangements.

2.6.2 We agree with Ofgem on the importance of clarity in terms of charging and will continue to work with Ofgem and Independent Connection Providers (ICPs) to develop proposals in this area.

³ Ofwat(2004) “Further guidance to companies for final Business Plans”. MD190, March 18th



2.6.3 Again as stated in previous consultation responses, we fully support the need for appropriate performance standards. The following principles are fundamental to the introduction of a satisfactory regime:

- standards must be clearly defined to enable accurate and consistent measurement and reporting;
- implementation costs must be fully funded;
- the number of standards must be proportional to those in place for other company activities, based on the value and relative importance;
- targets should only be finalised when robust and auditable statistics are available to verify reported performance, when a decision can be taken on whether to include payments; and
- it must be made clear to all parties that failure to meet service standards will not result in liability for consequential loss.

2.6.4 We agree with the proposal that financial penalties will not be attached to standards in this area at this price review. The standards to be applied should be those that have already been agreed with Ofgem on a voluntary basis, namely:

- the time to provide a firm quotation;
- the time to approve the contestable works design; and
- the percentage of non-contestable work requests completed on the agreed date.

2.7 BUSINESS RATES

2.7.1 We note Ofgem's comments in relation to business rates and await confirmation of the treatment of these costs in the June Initial Proposals. We have been very active in the process of establishing revised rateable values to ensure that costs are minimised. We would therefore expect these costs to be treated as pass-through.



2.8 *DEALING WITH UNCERTAINTY NEW OBLIGATIONS AND COSTS*

2.8.1 Our response to Ofgem's consultation of December 2003 stated our disappointment with the lack of progress in this key area. We continue to believe that formal mechanisms for dealing with uncertainty represent best regulatory practice and are in the best interests of all stakeholders. Ofgem has provided no satisfactory explanation as to why such formal mechanisms are not appropriate.

2.8.2 We reiterate the comments set out in previous consultation responses that, in order to remove the perception of regulatory risk associated with additional costs and new obligations, Ofgem must set out clear rules for dealing with cost increases between price reviews including:

- the circumstances under which the various mechanisms (such as error correction, interim adjustments, recovery during subsequent price controls) would be applied;
- the circumstances under which pass-through would be appropriate, and those under which efficiency tests would be applied; and
- the criteria that would be used to assess cost efficiency.

2.8.3 The ENA has recently submitted details of a mechanism that is designed to deal with uncertainty. We support this proposal which:

- by mitigating the additional risk borne by companies, will be beneficial for customers by preventing this increased risk from feeding through into the observed cost of capital, and so into prices;
- by preserving, as far as possible, the incentive properties of the main control with respect to costs that are too uncertain to be remunerated under that control;
- will enable Ofgem to set a level of allowed costs for the main control that is not unnecessarily inflated to cover elements of uncertainty; and
- should eliminate the risk that Ofgem's 'comfort statements' could become the subject of dispute or legal challenge.



2.8.4 We continue to believe that the Ofgem working group on incentives and uncertainty is the best forum in which to finalise this proposal. We remain committed to this working group and believe that it has a significant role to play in the resolution of this important issue.

2.9 INCENTIVE FRAMEWORK

Application of eligibility tests for efficiency savings

2.9.1 It is very important that subjective assessments are avoided and clear rules are established and documented for any eligibility tests that Ofgem intends to apply. These rules should be in place from the beginning of the period to which the eligibility test will be applied.

Retention period for efficiency savings

2.9.2 We remain strongly of the view that incentives to achieve efficiency savings need to be strengthened to ensure that customers continue to benefit from efficiency gains. Future gains will require greater effort and innovation and many initiatives will require up-front expenditure to stimulate future cost savings. We therefore support the introduction of rolling mechanisms to allow companies to retain efficiency savings for a period of 5- years.

2.9.3 We continue to believe that the rolling opex mechanism should exclude exceptional and atypical items as their inclusion could distort the incentive. We do not accept the point made by Ofgem that it would be necessary to define all such items in advance, rather it would be possible to deal with such items as and when they occur.

Definition of costs and incentives

2.9.4 Further detail is required, but we can see possible merit in the principle of adding fault expenditure, R&M expenditure and replacement capital expenditure into a modified RAV and incorporating adjusted depreciation to ensure that cash-flows are neutral overall. If such an approach is to be adopted then the costs incorporated into the RAV should be fully absorbed (i.e. including allocated overheads).

Incentives for investment deferral

2.9.5 We agree with Ofgem that the treatment of under-spends will require careful consideration at the next review particularly where large increases in capital expenditure have been allowed. However, we do not accept that incentives for capital efficiency are too strong and do not support any proposal to reduce the proportion of the present value of a saving that is retained by companies. In particular, we are strongly of the view that the same incentives for capex efficiency should apply regardless of the size of the capital programme.

Linking incentives to outputs

2.9.6 Ofgem has requested views on how to link capex incentives to outputs and to take account of differences in capex forecasts across companies. Current allowances for non-load related capital expenditure represent an asset turnover of over 100 years. It is, therefore, very unlikely that the impact of investment within a single price control period will be observable in terms of a measurable output. It will therefore be very difficult to link capex incentives to short-term outputs. However, we continue to believe that there is a strong case for an input based capex monitoring regime in some areas, including network resilience and loss reduction.



2.9.7 Our plans for the period 2005 to 2010, as submitted to Ofgem in our Forecast Business Plan Questionnaires (FBPQs), are the next stage of our longer-term plans to maintain network performance, safety and reliability for our customers. These plans are linked to longer-term outputs and it will therefore be possible to measure the long-term impact of capital investment.

Differences in capex forecasts across companies

2.9.8 Ofgem should not expect all companies to have similar capital investment requirements. It must be recognised that each company will have specific investment requirements driven by its own regional priorities, asset base (including age profile, mix, design, construction standards, condition and performance) and customer requirements. In addition, it must be recognised that companies are at different positions on the investment cycle.

2.9.9 Ofgem must use its assessment of Asset Risk Management (ARM) policies and practices of each company as a major determinant in establishing the credibility of investment plans.

Treatment of capital expenditure overspends

2.9.10 We note Ofgem's thinking on the treatment of capital expenditure overspends during the next price control period. In our view, all efficiently incurred expenditure should be included in the RAV and both the regulatory depreciation and return should be recoverable to preserve the NPV of the investment. The introduction of a test, over and above any efficiency test, of whether or not expenditure has provided significant benefits to customers will only serve to increase regulatory uncertainty. If clarity cannot be provided on the criteria that are to be used by Ofgem to assess this expenditure, then an eligibility test will not be appropriate.



2.9.11 Ofgem use security of supply as an example of an area that could justify additional capital expenditure. There are clearly other reasons, in addition to security of supply, where additional expenditure could be justified. For example unforeseen expenditure to improve safety or to provide environmental benefits such as lower energy losses or reduced emissions, facilitating additional distributed generation or enhancing amenity value, particularly in National Parks. Furthermore, additional expenditure may be necessary where there are unanticipated changes in Government policy, statute or other relevant regulations.

2.10 DISTRIBUTION LOSSES

2.10.1 We can support the proposals for losses in principle, so long as a number important outstanding areas of uncertainty are addressed:

- the efficiency test to be applied for loss reducing capex;
- the value attributed to each lost unit; and
- how the losses benchmark will be reset in 2010.

2.10.2 The proposals for a 5-year rolling mechanism for losses imply that companies will retain less than 30% of the benefit of reduced losses, broadly similar to the proportion retained under the present mechanism. If companies are to incur a similar proportion of costs then the earlier proposal for loss reducing capex to be added to the RAV after a 5-year lag should be revised. Funding the depreciation element of this capex during the initial 5-year period would lead to the company's share of expenditure being broadly equal to its share of the benefits from loss reduction.

2.10.3 Ofgem's proposal that companies should bear 1% of the costs of increased losses as a result of distributed generation is not acceptable. The rationale behind this approach appears to be that distributed generation (DG) will reduce losses in many cases and companies will receive payments through the DG incentive. We believe that this rationale is flawed.



- 2.10.4 We do not believe that there is a basis for the view that DG will reduce losses in many cases. The impact of high levels of DG on distribution losses is uncertain and it is not appropriate to introduce arrangements based on assumptions about the impact. Furthermore, a distribution company has no control over the impact that DG has on losses. This issue should be addressed at the next price review at which time it is very likely that companies and Ofgem will have a much better understanding of the impact of DG on losses. In the meantime, companies should not be exposed to bear any proportion of any increase in losses resulting from DG.
- 2.10.5 We do not accept that the incentive for the connection of DG should be used to compensate for the impact of increased losses caused by DG. The two incentives are separate and we believe that the incentive for DG connection will be undermined by potential exposure to the impact of DG on losses.

2.11 TREATMENT OF METERING

- 2.11.1 We continue to believe that a separate price control for metering is unnecessary and is not in customers' interests. However as stated in our response to the December consultation, we are committed to working with Ofgem to develop a suitable framework.
- 2.11.2 It is important that Ofgem's policy on metering does not inhibit innovation either in the provision of metering services or in the development of metering technology. Such innovation can provide direct benefits to customers and other network users. A number of European countries are investing in such innovation and it is important that the UK is not left behind.

Stranding

- 2.11.3 We continue to have significant concerns regarding stranding. Ofgem and the industry must continue to work together to ensure that these concerns are adequately addressed.

*Price cap/revenue cap*

- 2.11.4 As stated in previous consultation responses, we support the proposed DRC (Depreciated Replacement Cost) methodology for MAP services, and can accept a price cap on a 'basic' domestic meter providing that stranding issues are adequately dealt with. We can accept Ofgem's most recent proposal to use a technical based definition for a basic domestic meter.
- 2.11.5 Again as stated previously, we support an average revenue cap for MOp services based on the volume of works undertaken, providing that our concerns regarding the stranding of fixed costs required to discharge our obligations are addressed. We believe that revenue drivers should be kept to a minimum and would suggest the number of visits to each of the following distinct customer groups as appropriate drivers:
- single phase customers ;
 - three phase customers; and
 - customers with CT metering.
- 2.11.6 We believe that the revenue cap for MOp services should apply to all services as this will ensure that the volume of services relating to the revenue cap will be maximised. This should reduce the likelihood of the situation developing where the volume of services carried out by a company under its revenue cap are such that the level of the resultant charge would be unsustainable.
- 2.11.7 However, this situation could still occur and it is important that a solution is developed to deal with it. In our view, a pragmatic solution, to be implement only in the event of such a situation occurring, would be to allow companies to recover their fixed costs from meeting their obligations via the distribution price control.



2.11.8 Proper consideration must be given to the problem of price stability as a result of over/under recovery from the revenue cap for MOp services. Under and over recoveries are inevitable given the uncertainties in terms of volumes that will result from the introduction of competition. A pragmatic solution to this problem would be for over/under recovery to be passed through to the distribution price control.

Pre-payment metering

2.11.9 Ofgem correctly identifies a number of difficulties with the treatment of pre-payment metering arising out of the use of various different technologies. It is very important that Ofgem's treatment of pre-payment metering does not act as a barrier to the introduction of new technologies or the standardising of current technologies.

2.11.10 We believe that these difficulties can be resolved by setting the DRC costs of all existing pre-payment metering at zero. That is, existing pre-payment metering would remain in the distribution RAV. No termination charge would be levied in the event that an existing meter is replaced and the costs associated with the new meter would be recovered under the metering price control.

SECTION 3 - QUALITY OF SERVICE AND OTHER OUTPUTS

3.1 *GUARANTEED AND OVERALL STANDARDS OF PERFORMANCE (GOSPS)*

3.1.1 We remain of the view that GOSPs set extremely challenging targets and are a very effective means of providing protection to customers. As set out in previous consultation responses, there are a number of principles that must be recognised when considering changes to the current standards, including:

- the costs associated with meeting new or tightened standards must be appropriately funded;
- standards should not be set so tight so as to require networks to perform to a higher standard than required by the licence design standard P2/5;
- Guaranteed Standards (GS) should be seen as a means to compensate those customers who receive sub-optimal performance from time to time;
- the cost of GS payments that can be expected to be made by an efficient operator should be fully funded through the price control; and
- only repetitive GS failures for the same customers should be considered an indication of poor performance by a company, not individual failures.

Scope of exemptions to Guaranteed Standards – industrial action

3.1.2 We are extremely concerned that Ofgem is considering any change to this exemption. Our response to Ofgem's December paper stated that industrial action by employees is not within a company's control and accordingly, it is not appropriate to tighten or remove the exemption in this area. We agree with those respondents to the December paper who commented that any change could significantly alter the balance of power in trade union negotiations and may be detrimental to customers.

*Guaranteed Standards for supply restoration*

3.1.3 We support Ofgem's proposal to split the standard for supply restoration to cover 'normal' and 'severe weather' conditions. However it is extremely important that the boundary between the two categories is well defined and that no overlap exists.

3.1.4 Contrary to the statement in paragraph 4.11 of the Ofgem document, we do not accept that Ofgem's proposals in this area build on the interim arrangements introduced following the storms of October 2002. Rather, we believe that the proposals are a significant departure from the interim arrangements. Our concerns are dealt with in more detail in Section 3.3 of this response document but can be summarised as follows:

- we do not accept that further incentives on companies are required in this area;
- we believe that the complexity introduced by the four proposed bands of weather severity is unnecessary and will confuse customers, resulting in invalid claims and, potentially, requests for determinations; and
- companies have not been funded to construct networks that are totally resilient to severe weather and it is therefore inappropriate for companies to bear any proportion of the cost of compensation payments.

3.1.5 We are concerned that Ofgem appears to be proposing to use its assessment of customer willingness to pay as the prime driver for assessing Guaranteed Standards for multiple interruptions. The prime driver of these standards must be the licence standards to which the network has been designed i.e. its ability to perform. A more appropriate application of the analysis of customer willingness to pay would be in determining the investment to be targeted at improving the ability of the network to perform.

Multiple interruptions

3.1.6 The existing GS covering Multiple Interruptions was only introduced in 2002/03. The major problem with this GS is that customers do not understand it. This has led to well in excess of 20 invalid customer claims for every valid claim and a resulting administrative burden. The standard should be modified to make it more understandable, for example, by specifying a higher number of interruptions each lasting 3 minutes or more.

Compensation for business customers

3.1.7 It should be made clear to customers that GS payments are not compensation for consequential loss as a result of loss of supply. While we agree with the principle that GS payments should be linked to the general use of system charges paid by customers, any customer seeking compensation for consequential loss should rely on insurance.

3.1.8 We welcome confirmation that GS regime will not discriminate further between domestic customers and those business customers connected to the same low voltage networks. However we remain concerned that Ofgem is considering some element of further discrimination.

3.1.9 Very large customers have the ability to directly influence the security and reliability of their supply as each connection is designed and priced individually. Compensation payments should therefore not simply be linked to a general willingness to pay, as identified by Ofgem's survey, but to the actual willingness to pay demonstrated by individual customers through the security of the connection that they have chosen.

*Priority service customers*

3.1.10 As stated in our response to the December document, we are committed to meeting the special needs of our priority customers and welcome the opportunity to work with Ofgem, the rest of the industry and other stakeholders to further develop the services provided to such customers. We agree with Ofgem that a new standard of performance in this area is not appropriate.

The role of Overall Standards

3.1.11 We agree with the proposal to replace Overall Standards with additional reporting via the IIP Information Template.

Automatic payments

3.1.12 We believe that the introduction of a semi-automatic payment process for the current 18-hour supply restoration standard is a cost-effective alternative to the earlier proposals requiring a full phase connectivity model. We would also welcome Ofgem's confirmation that the company should deal directly with the customers for such payments rather than being required to make such payments via suppliers.

3.1.13 As stated in paragraph 3.1.1, networks designed in accordance with P2/5 are, by design, expected to incur payments under the 18-hour standard. The background level of payments should therefore be funded through the price control. We believe that the introduction of a scheme where a revenue penalty is applied based on the number of eligible customers that do not claim is not appropriate, as this would increase the level of background funding required from customers.



3.2 **REVIEWING IIP**

3.2.1 We are generally supportive of Ofgem's proposals in this area. Previous consultation responses have provided detailed comments on the scope of the output based incentive regime. In general, our views can be summarised as follows:

- the focus of improvements to the incentive framework must be on refining the operation of IIP (as applied to the existing output measures) rather than significantly extending the range of output measures;
- the scope of output measures should be based on measures required to protect customers' interests, informed by robust research into priorities and willingness to pay;
- the incentive mechanism needs to become more balanced, providing equal opportunities for rewards and penalties each year; and
- the costs of achieving any expected improvement in performance should be considered on a company specific basis, and would require full funding through an appropriate allowance.

Our detailed comments on Ofgem's proposals are provided in the following paragraphs.

Provision of disaggregated interruption data

3.2.2 We support the proposals to modify the RIGs (Regulatory Instructions and Guidance) to include disaggregation by HV circuit and disaggregation of interruptions by time band. In addition, we agree that it is not appropriate to introduce performance targets in this area at this review.

3.2.3 We agree that the ongoing provision of performance data disaggregated by HV circuit will not incur significant additional cost. However, we have already incurred costs of over £1m in developing our ability to supply this data and should be remunerated for these costs via the next price control.

Worst served customers

- 3.2.4 We support appropriate initiatives to improve the network performance experienced by ‘worst-served’ customers as companies should be funded and incentivised to target investment at such customers. Indeed, the DNO Alternative Scenario from our FBPQ submission makes provision for investment to be targeted towards those customers who are consistently worst served and towards those communities who are most at risk of experiencing future multiple supply interruptions.
- 3.2.5 Our previous consultation responses have emphasised the importance of improving the performance experienced by ‘worst served’ customers. We therefore support the proposal to modify the RIGs to introduce a new requirement for reporting the number of customers experiencing particular frequencies of interruption each year.

Connections

- 3.2.6 We agree that, with the removal of Overall Standards, it is appropriate to transfer the reporting requirement for the percentage of connections provided within 30 or 40 days to the IIP outputs framework.

Form of the incentive regime

- 3.2.7 We support the move towards annual rewards and penalties. In order for the scheme to be effective it must truly symmetrical, providing equal opportunity for annual rewards and penalties of equal magnitude. In addition, the process to exclude severe weather and other exceptional events needs to be mechanistic, using pre-defined criteria without the need for any subjectivity on behalf of the assessor. This will speed up the process of annual reporting and facilitate early settlement of the annual incentive mechanism.



3.2.8 We believe that that for the incentive mechanism to have a real impact on the behaviour of companies it is necessary for the settlement of rewards and penalties to have a more immediate impact upon revenues. However we acknowledge that attention needs to be given to ensuring that prices to customers remain relatively stable. We would therefore support the introduction of a mechanism to spread the payment of annual rewards and penalties over, say, a five-year period.

Weighting of planned/unplanned interruptions

3.2.9 Companies have, over many years, invested heavily in staff training, equipment and the development of working practices to enable a wide range of work to be undertaken using live working techniques. Any move to reduce the weighting on pre-arranged interruptions within the incentive mechanism would weaken the incentive on companies to continue to use such techniques, particularly those that incur considerable additional expenditure. The reduced use of such techniques would be to the detriment of customers and we therefore urge Ofgem to continue to place equal weighting on both planned and unplanned interruptions.

Audits and adjusting data for inaccuracy

3.2.10 It is in the interests of customers and companies that reporting of interruption data meets the required levels of accuracy. In our view an annual audit of all companies will best achieve this objective. We believe that further work is required to ensure that such audits are undertaken against well-defined reporting requirements and a clear understanding of 'the required level of accuracy'.



3.2.11 We support the continuation of the current audit arrangements for at least the next two to three years. However, once the stage is reached where audits are not identifying any significant issues or discontinuities between companies, we would propose a move to an annual process with far less Ofgem involvement where:

- Ofgem identifies the incidents to be audited;
- the DNO audits the incidents and produces a draft audit report, and
- Ofgem undertake only an audit of say 10% of the incidents audited by the DNO to check the accuracy of the DNO's audit work.

3.2.12 We disagree with the proposal to adjust reported performance in line with the results of the sample audit unless the audit involves a much larger sample size. The size of the audit sample is designed to reflect the accuracy of the overall data set only within certain confidence limits and it would not be appropriate to assume that the sample provides a better view of reporting accuracy than is contained in the overall data set.

Target setting

3.2.13 We note that targets under the incentive regime will be addressed in the June proposals. As stated in previous consultation responses, it is important that these targets reflect the current performance of companies and the level of allowed investment during the next price control period.

Frontier performance

3.2.14 We support the proposal to modify the rules of the 2004/05 incentive mechanism to allow frontier performing companies in terms of quality relative to the disaggregated benchmark, to participate in the reward mechanism whether or not they achieve both their CI and CML targets.



3.3 *NETWORK RESILIENCE*

3.3.1 We agree with Ofgem's conclusion that it will not be possible to develop a robust incentive mechanism for the initial impact of a storm as part of this price control review. We look forward to continued dialogue with Ofgem on this matter.

3.3.2 Our responses to previous consultation papers have identified four factors that determine network resilience:

- line construction;
- tree management;
- line maintenance; and
- response.

3.3.3 These responses further stated that network resilience can only be maintained and improved if all four of the factors listed above are adequately addressed and appropriately funded. Adequate, and in many cases, increased funding is therefore key to network resilience. Our FBPQ (Forecast Business plan Questionnaire) submissions make provision for increased investment to improve the ability of our network to withstand severe weather events. However, it should be noted that the impact of such investments will take many years to become visible.

Restoration following a severe weather event

3.3.4 Ofgem's latest proposals in this area are not acceptable. Public scrutiny, company reputation and the current financial incentives imposed by GS2 and the 'Interim Arrangements' already provide companies with very strong incentives and no further incentives are required. The Interim Arrangements were developed following lengthy discussions between Ofgem and companies and we are disappointed that Ofgem is considering significant changes to these arrangements.

3.3.5 Our main concerns are as follows:

- the complexity introduced by the four proposed bands of weather severity is unnecessary and will confuse customers, resulting in invalid claims and, potentially, requests for determinations; and
- companies have not been funded to construct networks that are resilient to severe weather events and it is therefore inappropriate for companies to bear any significant proportion of the cost of compensation payments.

3.3.6 We would urge Ofgem to keep this process simple by continuing to adopt the three bands of event identified by the Interim Arrangements, perhaps adjusting the start time for payments if that is desired and funded by customers. Our experience with the type of storms that are expected to trigger the Interim Arrangements indicates that most customer supplies will be restored by between 48 and 96 hours from the start of an event. We would therefore accept the continuation of the existing sliding scale of cost recovery for the period beyond 48 hours.

3.3.7 We welcome confirmation that all CIs and CMLs associated with severe weather events will be excluded from the IIP mechanism. However, we are very concerned that Ofgem's proposals will significantly increase the exposure of companies to compensation payments particularly those that relate to factors, such as severe weather, over which companies have no control. . This would change the risk profile of companies significantly.



3.3.8 It is appropriate therefore to carry forward the cap of 1% of revenue on exposure to compensation payments within the Interim Arrangements to the next PCR period. We note Ofgem's comments that expenditure associated with faults will be treated as capital expenditure during the next price control period but consider this to be irrelevant to the issue of exposure to compensation payments.

3.4 *DRAFT REGULATORY INSTRUCTIONS AND GUIDANCE (RIGS)*

3.4.1 We support Ofgem's work to develop a version of the RIGs to reflect the revised reporting requirements that will become effective from April 2005 as a result of the ongoing price review consultations.

3.4.2 The draft version 5 of the RIGs published in March is an excellent first step in this process. In our view, the effective communication that exists between Ofgem and the companies via the Quality of Supply working group is the appropriate forum for the detailed discussions and comments that are needed to further develop the draft. We look forward to regular ongoing discussion with Ofgem in this regard and would suggest that a further, more refined, draft is formally circulated to a wider audience for comment later in the price review process.

3.5 *TELEPHONY INCENTIVES*

3.5.1 We support Ofgem's move to include customers who receive automated messages in the customer satisfaction survey and we note the intention to review the questions in the telephone survey. We believe that such a review is appropriate and would be pleased to work with the interested parties identified by Ofgem in this review.



3.5.2 We continue to have concerns around a subjective assessment of Speed of Answering. As a general principle, any incentive should, where possible, be based on a measurable output and should not be based on a subjective assessment of performance. It is therefore inappropriate to combine the Speed of Answering and Quality of Service incentives by the incorporation of a question on Speed of Answering.

3.5.3 We note that consideration is being given to whether or not the incentive scheme should be based on absolute or relative performance. It is not appropriate to move to an absolute scheme given the intention to change survey questions as there will be no historic performance information to aid the setting of appropriate targets. We therefore propose that Ofgem retain the existing relative incentive mechanism.

3.6 ENVIRONMENTAL OUTPUTS

3.6.4 We continue to believe that it is unnecessary for companies to report environmental performance to Ofgem as this will involve duplication of effort. We note that it is not Ofgem's intention to introduce financial incentives on these outputs for the next price control period. We would add that financial incentives will not be appropriate at any time as this could result in companies being exposed to double jeopardy given that financial penalties can be imposed by other regulatory bodies in this area.

SECTION 4 - DISTRIBUTED GENERATION

4.1 *INCENTIVE FRAMEWORK FOR DISTRIBUTED GENERATION*

4.1.1 Distributed Generation (DG) is a much more significant issue for our businesses than for most other distribution companies. According to the consolidated figures from the Distributed Generation Business Plan Questionnaires (DGBPQs) provided in Ofgem's October 2003 consultation paper, approximately 25% of the total anticipated volume of distributed generation will locate in our licensed areas. It is therefore one of our primary concerns from this price review that an effective mechanism is introduced to facilitate Government targets.

4.1.2 We remain supportive of Ofgem's objectives in this area and believe that progress has been made towards the development of acceptable proposals. However we believe that it is premature to make statements relating to "barriers being swept away". We continue to have some concerns with Ofgem's proposals and believe that there are aspects of these proposals that will undermine incentives to connect DG. In particular these concerns relate to:

- the exposure of companies to forecast levels of DG not being achieved or sustained;
- the proposed availability incentive; and
- the impact of the losses incentive.

4.1.3 These issues are dealt with in detail in the following paragraphs. We remain committed to working with Ofgem and other stakeholders to ensure that satisfactory arrangements can be introduced. However it is important, if Government targets are to be met, that a commitment exists from Ofgem to review these arrangements if they are not effective in practice.

Recovery of pass-through costs

4.1.4 We are working closely with Ofgem, via the Structure of Charges Implementation Steering Group, on the charging issues associated with Ofgem's proposals. We note Ofgem's comment that there is likely to be an element of under-recovery of costs initially but welcome confirmation that the costs associated with the pass-through element would have to be recovered from demand customers if the charging base for generation was very small or non-existent.

The value of the incentive rate

4.1.5 We note Ofgem's proposals for the value of the incentive rate. We are not in a position to comment on the increased incentive rate proposed for Scottish Hydro-Electric as we do not have access to any detail on their forecast costs. However we agree with the principle that a higher incentive rate should be applied if costs are higher than the assumptions used by Ofgem in setting the incentive rate. It must be borne in mind that the incentive rate is based on forecast costs. If efficiently incurred costs for other companies are significantly higher than the basis of Ofgem's assumptions then the incentive rate should be increased retrospectively.

O&M costs

4.1.6 We note Ofgem's proposal for the recovery of increased operating costs as a result of DG and the intention to review the £/kW rate in 2010 and pass any reduction in costs back to generators. We would add that if actual costs are higher than those anticipated then this should be reflected in the future allowance.



4.1.7 We do not agree that all of the increased operating costs associated with DG should be funded via the incentive mechanism, as companies will incur costs regardless of whether or not all of the anticipated generation is connected. Consideration must therefore be given to funding some of these costs in advance of connection.

Recovery of the incentive rate

4.1.8 We remain concerned that the incentive rate in respect of a particular generator will only apply whilst that generator remains connected to the distribution network. It is entirely outwith the control of a distribution company if a generator disconnects from the distribution network. We continue to be opposed in principle to this aspect of Ofgem's proposals but, in the interests of developing a better understanding of these proposals, would raise the following issues:

- consideration must be given as to when a generator is deemed to have disconnected; and
- clarification is required as to the period to which the incentive rate will be applied.

4.1.9 In order to be deemed to be disconnected, the generator must give up all rights to the connection by terminating the connection agreement. This will ensure that generators are not able to 'game' the system by temporarily declaring their output at zero.

4.1.10 In our view the incentive rate should apply for as long as a generator remains connected and not just until the asset is fully depreciated. This will avoid the situation of a generator connecting in year 10 of an asset's life, having an obligation only to pay the incentive rate for 5 years. We note from Ofgem's proposals that the incentive rate at the time of the connection will remain in place until the asset is fully depreciated however it remains unclear as to what will happen after the asset is fully depreciated.



4.1.11 We welcome Ofgem's intention, in the event of capacity being released by generation and subsequently utilised by demand, to allow the distribution company to reallocate 100% of the costs to load related reinforcement and for these costs to be included in the RAV. However, it is very important that the criteria that will be used to determine whether or not capacity is being utilised by demand are established and documented in advance.

Floor and cap on returns

4.1.12 In general, it is not appropriate that companies can earn excessively high or excessively low returns from DG investment. We therefore support the principle of a cap and a floor on overall investment in DG.

4.1.13 We agree that a cap of twice the allowed cost of capital is broadly appropriate but are concerned that a floor equal to the cost of debt does not provide sufficient downside protection.

Deep reinforcement

4.1.14 We note that Ofgem does not propose to make any specific allowances for deep reinforcement (referred to as strategic investment in the Ofgem paper). We continue to believe that there are many instances where the most effective and efficient means of facilitating DG will be to carry out advanced deep reinforcement. We urge Ofgem to reconsider this issue.

High-cost projects

4.1.15 We welcome the recognition that there may instances where costs are higher than those envisaged in setting the incentive rate and where excess costs can be recovered via connection charges to individual generators. However we do not accept that this should only include projects with costs in excess of £200/kW. This will effectively act as a barrier to the construction of schemes in the range of £50-£200/kW. It is not in the interests of generators for Ofgem to limit their flexibility to agree specific charging arrangements for high cost schemes.

Microgeneration

4.1.16 We note that Ofgem is considering whether financial incentives should apply to microgeneration. The costs that will be imposed by the connection of microgeneration will vary. Costs are likely to be zero for individual connections but could be significant in areas where there is a programme of connection.

4.1.17 Where schemes do impose costs then it is appropriate that these are borne by the party or parties that incur them. We note that charging design is under consideration in Ofgem's structure of charges workstream. Until charging rules can be finalised any costs associated with microgeneration could be treated as load related reinforcement and secured in the RAV.

4.1.18 We agree that a robust reporting framework is required. It is reasonable, as suggested by Ofgem, to use the definitions in the Distributed Generation Business Plan Questionnaire (DGPQ) as the basis for a starting point, however significant work will be involved in developing the reporting framework and associated guidelines. In our view, the best approach to the development of this framework would be to establish a working group comprised of representatives from Ofgem and the companies. We would be pleased to participate in such a working group.



4.1.19 It is possible that the administration and reporting costs associated with the DG incentive could be significant. Such costs should be fully funded via a separate mechanism from the DG incentive.

4.2 INCENTIVES FOR NETWORK AVAILABILITY

4.2.1 We are concerned that Ofgem's proposal for a network availability incentive will undermine the incentive to connect DG. We have consistently pointed out the problems associated with the introduction of an incentive for network availability. These problems arise from the standards to which the distribution network has historically been designed and operated and from the tendency for generators to opt for the least cost connection. In summary:

- the distribution network is designed in accordance with the licence design standard P2/5;
- this standard does not provide for 100% availability, is not a connection standard and does not consider distributed generation;
- a revised standard, P2/6, is currently being developed, this will consider distributed generation but will not specify connection standards;
- no experience is available of the operation of distribution networks with significant amounts of distributed generation; and
- there is a tendency for generators to opt for single circuit connections in order to minimise cost.



4.2.2 We believe that the introduction of an availability incentive at this price review is not appropriate because of the issues set out above. If an availability incentive is to be contemplated for the next price review then further work is required in a number of areas including the development of connection standards and the impact of high levels of distributed generation. The following fundamental principles should apply to any scheme:

- it should be symmetrical (i.e. opportunities for rewards and penalties) around a figure of, for example, 99%;
- it should incorporate exemptions during severe weather events; and
- it should not be applicable to faults and outages on sole use connection assets where the generator has opted for a single circuit connection.

4.3 INNOVATION FUNDING INCENTIVES

4.3.1 Our previous consultation responses have supported Ofgem's objectives for IFI funding as it is important that companies are enabled and encouraged to seek out new techniques and technologies. We believe that increased levels of R&D expenditure, driven by IFI incentives, will deliver benefits to customers that are not available via current regulatory incentives.

R&D intensity cap

4.3.2 We agree that the R&D intensity cap of 0.5%, on a use it or lose it basis, is reasonable.

Level of pass-through

4.3.3 We continue to believe that the proportion of pass-through of IFI funding should be at least 90% for the duration of the next price-control period. A reduced level of pass-through would not provide companies with sufficient certainty of cost-recovery. We note that the majority of respondents to Ofgem's December paper favoured a level of pass-through in excess of the average level of 80% proposed by Ofgem and are disappointed that Ofgem has not acted on these responses. We urge Ofgem to reconsider this proposal.

Level of direct internal funding

4.3.4 We welcome recognition from Ofgem that companies will require to invest a certain amount of their own resources in order to pursue IFI projects successfully. Given this recognition, we do not think that it is appropriate for such internal expenditure to be capped. The focus should be on ensuring that customer benefits can be delivered rather than on whether or not they are delivered through internal or external spend. Our experience indicates that R&D projects require a significant input from internal resources and we believe that this proposal will significantly reduce the benefits that can be delivered.

IFI criteria

4.3.5 We believe that the criteria for IFI projects should be relatively wide to avoid excluding projects that could provide benefits. Once further experience has been gained of the operation of the IFI incentive then it is possible that the criteria could be tightened. In our view the following high level criteria are appropriate:

- based on known technology;
- directly applicable to distribution networks; and
- is considered likely to provide tangible benefits to customers.

*Good practice guide*

4.3.6 We support the introduction of a good practice guide for managing R&D projects.

4.3.7 In our view companies and Ofgem should work together to agree the form and content of a good practice guide as soon as possible. However, in the interim and until such time as a guide is developed and endorsed by Ofgem, projects that meet the IFI criteria should be allowed to progress. This should apply to projects in the current price control period.

Reporting

4.3.8 We agree with the principle of open reporting of IFI activities as long as the reporting burden can be minimised.

4.4 REGISTERED POWER ZONES (RPZ)

4.4.1 We support Ofgem's stated objectives for RPZs. As stated in previous consultation responses, it is important that companies are enabled and encouraged to seek out new techniques and technologies where they are appropriate and provide benefits to customers.

Defining criteria for RPZs

4.4.2 In our opinion decisions on RPZs should be driven by effectiveness in terms of the amount of generation that could be accommodated and the potential cost savings that might result.

Potential barriers

4.4.3 We note Ofgem's view that the risk of failure of an RPZ project should be covered by the potential for earning a higher rate of return. Given the small number of projects that will be implemented by each company, we continue to believe that RPZ incentives will be weakened significantly if there is no mechanism for funding a 'traditional' solution in the event of the RPZ solution being unsuccessful. We therefore urge Ofgem to reconsider its proposal on this issue.

Good practice guide

4.4.4 As previously stated, we support the introduction of a good practice guide.

SECTION 5 - ASSESSING COSTS

5.1 GENERAL

5.1.1 We have previously commented in detail on Ofgem's approach to cost assessment. These comments remain valid. We agree with Ofgem that a number of key issues remain unresolved and believe that the best forum for the resolution of these issues is Ofgem's Cost Assessment working group.

5.1.2 We would reiterate the importance of transparency of outcome. A clear audit trail must be provided to enable each company to clearly understand Ofgem's analysis.

5.1.3 The findings of Ofgem's analysis and reports from the various visits must be made available to companies at the earliest opportunity. This is essential in order to provide companies with sufficient time to consider this information, correct any inaccuracies or misunderstandings and respond to Ofgem before it is made public or initial proposals are produced.

5.2 FORECAST COSTS

5.2.1 Our plans, as submitted to Ofgem via our Forecast Business Plan Questionnaires (FBPQs), are based on continuing to manage our distribution network to be sustainable in the long-term. This will ensure that our customers continue to receive reliable electricity supplies, efficiently managed and resilient to the increasing risk posed by severe weather events. The plans that we have recommended to Ofgem for the period 2005-2010 are the next stage of our longer-term plans to ensure that we meet these commitments to our customers.

5.2.2 In compiling these plans we have recognised that this distribution price control review is different from previous reviews due to increasing costs in a number of areas, including network safety, security and reliability and distributed generation. These cost increases result in an upward pressure on prices.



- 5.2.3 Our plans are based on advanced asset risk management policies and practices and take account of the increased levels of asset replacement required to manage the risks associated with the ageing asset base.

Operating expenditure

- 5.2.4 Our plans include the operating expenditure required to address the considerable cost pressures impacting our businesses and to deliver the increasing service levels required by our customers. Costs are increasing in a number of areas, including contractor rates for tree cutting, insurance premiums and the costs resulting from complying with changes in legislation and with increasingly onerous environmental obligations.

Capital expenditure

- 5.2.5 We note Ofgem's comments around the range of capital expenditure forecasts provided by companies. As stated previously, Ofgem must use its assessment of Asset Risk Management (ARM) policies and practices of each company as a major determinant in establishing the credibility of investment plans. In addition, it should be recognised that each company will have specific investment requirements driven by its own regional priorities, asset base and customer requirements.

5.3 NORMALISED DATA

- 5.3.1 We recognise that Ofgem have much to do in terms of the normalisation process and are actively working with Ofgem in this area. However, as stated in previous consultation responses, if cost data cannot be adequately normalised, then the basis for relative comparison will be undermined and less weight should be given to the results.



5.3.2 Ofgem must undertake analysis to examine how sensitive the results are to different assumptions or to the inclusion of particular data. Results that are highly sensitive to different assumptions/data will not be robust enough to be used in the price control review.

5.4 ANALYSIS OF FAULT COSTS

5.4.1 It is apparent from the numbers that are currently available that there is a significant boundary issue between post-fault and other asset replacement capex. Unless this issue can be resolved then fault costs should be excluded from any comparative analysis.

5.4.2 We are very concerned at Ofgem's apparent intention to include total fault costs together with controllable operating costs in the top-down analysis. Total fault costs are significant when compared to other controllable costs and should be modelled separately on a bottom-up, company specific, basis using Ofgem's assessment of efficient unit costs for each activity multiplied by the volume of activity.

5.4.3 Any analysis of fault costs must take account of the appropriate cost drivers including overhead/underground mix, regional factors and asset age. In addition, costs must be normalised to exclude the effect of severe weather events.

5.4.4 Separate modelling of fault costs should improve the clarity of future allowances and minimise the risk of a re-occurrence of the RAV roll-forward issues that have arisen during the current price control period.

5.5 BOTTOM – UP MODELLING

5.5.1 We note that Ofgem is taking advice from PB Power in this area but are concerned that we have not yet seen any detailed output from PB Power's modelling. As previously stated, it is imperative that we receive copies of PB Power's models in order that we can replicate the output.



5.5.2 Particular care must be exercised when undertaking bottom-up modelling. Companies do not generally have common cost allocation procedures and, consequently, unit costs for individual activities will not be directly comparable. In addition, difficulties will arise as a result of different organisational structures and varying degrees of outsourcing. As stated in previous consultation responses, in our view, the most pragmatic and effective approach to these issues is to focus on ‘fully absorbed’ costs (i.e. inclusive of all allocated overheads) at an aggregated level rather than on an excessively detailed analysis of the overhead pool of each company.

5.5.3 We continue to be concerned that an excessively detailed approach could lead to the setting of a lowest cost benchmark for each activity or cost category. This could result in an overall benchmark that is below that attained by any one company and is effectively unattainable. In addition, we are concerned that an excessively detailed approach will be data and resource intensive.

5.6 TOP - DOWN ANALYSIS

5.5.1 As stated in previous consultation responses, the strict use of frontier benchmarks would result in an over-estimation of the potential for cost-reductions because of data consistency problems and comparability issues between companies. An average benchmark is more appropriate as it can be estimated with more certainty. In addition, it should be noted that any estimate of relative efficiency will contain significant statistical noise. The weighting given by Ofgem to such estimates must take proper account of this to ensure that the results are sufficiently robust.

5.5.2 The use of a frontier benchmark would be inconsistent with standard approaches to estimating the cost of capital. The risk adjusted market rate of return relates to average performance. In competitive industries, companies on or near the efficiency frontier earn above average rates of return.



5.5.3 Measures of quality should be included in the assessment of the efficiency of distribution companies. Otherwise, companies could be rewarded for reducing the quality of service, contrary to the interests of customers. Costs are clearly affected by the quality of service provided and any assessment that ignores quality would not be appropriate. The most important aspects of quality are the number and duration of interruptions to supply.

5.7 SCOPE FOR FUTURE EFFICIENCY IMPROVEMENT

5.7.1 As set out in some detail in our response to the December paper, we believe that the study by Cambridge Economic Policy Associates (CEPA) of Total Factor Productivity (TFP) significantly over-estimates the scope for further efficiency improvements. Our concerns are summarised in the following paragraphs.

5.7.2 There is considerable doubt as to the robustness of TFP studies. Past performance trends do not provide a good indicator of the future because of the significant transitory gains that have been achieved in the period since privatisation but which cannot be repeated in the future.

5.7.3 It is not appropriate for price controls to anticipate, through the pre-determined X factor, all of the potential efficiency and productivity gains that may be achievable in future. This would significantly reduce the incentives for companies to deliver such potential gains.

5.7.4 Estimates of TFP improvement include a substantial element of catch-up within the industry. Were Ofgem to persist with estimating a frontier, then it would be inappropriate to assume that the frontier could shift at the rate of industry TFP improvement. A consistent approach would require a disaggregation of the potential for TFP improvement, above that for the economy as a whole, into catch-up and frontier shift components.



5.7.5 We are concerned that Ofgem are seeking to impose both excessively rapid catch-up and continuing frontier shift at a rate significantly above that attainable for the economy as a whole. The combined effect assumes a future rate of TFP improvement that is unsubstantiated and totally unrealistic. Furthermore, we are very concerned that Ofgem will effectively double count the potential for future productivity gains by assuming scope for both efficiency savings and substantial quality improvements, at the same time.

5.8 *TREATMENT OF MERGERS*

5.8.1 Our previous consultation responses have made the following points regarding the treatment of mergers:

- all mergers should be treated on a consistent basis;
- merger savings must be treated like any other efficiency saving and captured via comparative analysis; and
- it is not valid to assume that merged companies should be on the efficiency frontier as there are now more merged companies than non-merged companies.

5.8.2 We have also previously made the point that Ofgem's policy of reducing revenues by £12.5m has only been applied to ScottishPower/Manweb. There must be no further revenue reductions applied in respect of this transaction as merger savings will be captured by comparative analysis. In addition, by the end of this price-control period we will have paid more than any other merged entity. Consistency of approach will require that that we be allowed to recover the excess payment during the next price control period.

5.8.3 We welcome recognition by Ofgem that the savings achievable through DNO mergers are also achievable through other corporate structures and that, as a result, no adjustment is necessary to adjust for merger savings for the purposes of benchmarking. We await Ofgem's further thinking on this important issue.



5.9 *RAV ROLL-FORWARD*

5.9.1 Our response to the December consultation document set out the following principles:

- we agree with Ofgem that definitions of expenditure need to be agreed and clearly communicated and documented;
- we also agree entirely with the principle that customers should not pay twice for particular items of expenditure; however
- companies must be adequately funded for properly incurred expenditure.

5.9.2 We note that Ofgem is reviewing the submissions made by companies in response to the issues raised in the December paper in relation to the categorisation of fault expenditure at the last price review. In summary our position is as follows:

- we have always accounted for fault repair costs as operational expenditure and for post-fault replacement costs as capital expenditure; and
- the cost of post-fault asset replacement must, like all other capital expenditure, be added to the RAV.

5.9.3 We have made several submissions and presentations to Ofgem on this issue. Given its importance, we are disappointed to have received no formal response from Ofgem. Furthermore, while we have submitted what we believe to be conclusive evidence in support of our position, we have received no evidence from Ofgem to support a position to the contrary.

5.9.4 We reiterate our position that the costs of post-fault asset replacement during the current price control period must, like all other capital expenditure, be added to the RAV. We urge Ofgem to confirm this position as a matter of priority.



SECTION 6 - FINANCIAL ISSUES

6.1 *FINANCIAL RING-FENCE*

6.1.1 We agree with Ofgem that there is no need for substantial strengthening of the existing financial ring-fencing arrangements and note the proposal for a formal 'cash lock up mechanism' to be applied under specific circumstances. As stated in previous responses, we do not think that such a mechanism is necessary as current licence provisions are perfectly adequate.

6.2 *THE COST OF CAPITAL*

6.2.1 We note Ofgem's initial estimate of the range for the allowed cost of capital of between 5.1% and 5.9% (vanilla). In our view, based on market evidence and authoritative academic studies, the top-end of this range should be extended by additional allowances for embedded debt and for debt issuance costs. In addition the allowed figure should be towards the top-end of this extended range. The following paragraphs set out the rationale for this position.

General approach

6.2.2 We are pleased that Ofgem has acknowledged the importance of providing a sufficient and stable return to attract funding from capital markets. Flexible and efficient access to these markets is vital to enable companies to invest and deliver networks that meet the demands of future generators and consumers.

6.2.3 We continue to believe that future investment confidence would be undermined by a cost of capital that is set 'too low'. This would have serious implications for the long-term sustainability of the electricity infrastructure and the achievement of Government targets for renewable generation. Consequently it is important that the allowed figure is that the top-end of any estimated range.



- 6.2.4 It is well recognised that the Capital Asset Pricing Model (CAPM) under-estimates the required rate of return because it ignores the negative ‘skewing’ caused by incentive regimes such as IIP. It is therefore important that the allowed return is set towards the upper-end of the appropriate range, rather than simply at the mid-point, to allow for this under-estimate.
- 6.2.5 There is considerable regulatory precedence for using the Dividend Growth Model (DGM) as a check on the results of the CAPM. Recent academic research shows that the cost of equity estimates using DGM are at the higher end of the range identified by CAPM for the distribution companies, even when a beta value of 1 is used.
- 6.2.6 Market evidence over the current regulatory period implies a dividend yield of 4.9 to 6.8% with a mid-point of 5.9%. With growth of 1 to 2%, this supports a post tax cost of equity of around 7.5%, in line with the ‘High’ end of the range outlined by Ofgem, consistent with a fully post tax WACC of 5.0% (5.9% vanilla).

Risk-free rate

- 6.2.7 Ofgem initial estimate of the range for the risk-free rate is 2.25% to 3%. Based on regulatory precedent, we believe that the range is between 2.5% and 3%.

Debt premium

- 6.2.8 Ofgem’s initial range of between 1% and 1.8% range is too low as it does not take account of the cost of efficiently incurred historic debt or of debt issuance costs. We believe that the figure at the top-end of the range should be increased by 0.5% to account for these factors.



- 6.2.9 As set out in previous consultation responses the allowed cost of debt must take account of efficiently incurred historical debt. We do not believe that Ofgem's initial estimate of cost of debt takes adequate account of this. An efficiently financed company will have raised debt over a long period in the past, arriving at a relatively stable real interest cost over time. This will not be the same as the current cost of debt as determined by forward looking data but is more likely to be the average of historic rates over a period of, say, 10 to 15 years. The average debt premium in the period since privatisation is 2.2% well above the Ofgem estimated range of 1% to 1.8%.
- 6.2.10 An appropriate allowance for debt issuance expenses should be included. The report by NERA supports a figure of at least 0.1% for debt issuance.

Treatment of tax

- 6.2.11 We continue to believe that the approach to the treatment of tax must provide a strong incentive for companies to maintain tax liabilities at an appropriate and stable level over the medium to long-term. Given that Ofgem has confirmed that a post-tax cost of capital will be applied, the strongest incentives for tax efficiency and stability will be achieved through setting tax allowances based on the average industry position.

6.3 PENSIONS

- 6.3.1 We remain supportive of Ofgem's work in this area and will continue to work with Ofgem with a view to securing a fair and pragmatic outcome on this complicated issue. The main outstanding issue from our perspective is the treatment of Early Retirement Deficiency Costs. Our comments on the issues raised by Ofgem's paper are provided in the following paragraphs.

Allocation between price controlled and non-price controlled activities

6.3.2 We are generally supportive of Ofgem's work on this issue. We await clarification of the final approach in due course.

Over or under provision

6.3.3 Previous price controls have not made any explicit allowance for pension costs. We therefore support Ofgem's decision not to make any adjustments for over or under funding in previous price controls as being the only reasonable position that could be adopted.

6.3.4 There is no basis for the statements in paragraph 7.39 of the Policy document that companies have "probably contributed substantially less than was allowed in setting the price controls since 1995". We do not see how this statement can be supported given that there has previously been no explicit allowance for pensions costs and given the lack of transparency as to the treatment of frontier companies at DPCR3.

Early retirement deficiency costs (ERDC)

6.3.5 We are disappointed that Ofgem appears minded not to allow any ex-post pass through of ERDCs to customers. As previously stated, the provision of pension benefits under severance arrangements has resulted in direct savings to customers. Costs, past and future, associated with the provision of these benefits must be treated as a legitimate business cost.

6.3.6 We continue to believe that a balanced approach is required that recognises the benefits that have been delivered to both customers and shareholders from the use of surpluses to fund severance programmes. Funding of such costs from surplus is entirely legitimate and Ofgem have never given any indication that these costs could not be recovered.



6.3.7 Under the proposals for operating cost efficiencies around 70% of cost savings are passed back to customers. It is only equitable that a similar approach is taken to the costs that have enabled these savings to be achieved.