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Distribution Price Control - Initial Proposals

Dear David

This is the response of Central Networks to the Initial Proposals made at the end of June. We are sending you an early response to facilitate discussion and resolution of a number of key issues before the planned September update.

I have attached responses to the main document only, excluding responses requested for some of the appendices. We are working on these and will be sending them to you for the 9th August deadline, when we may also add to the main response in the light of any subsequent developments.

Since publication of the Initial Proposals we have had meetings with you and GEMA, which helped to illuminate the key issues between us. In addition we have recently seen copies of the PB Power and Ernst & Young reports and have been promised visibility of the derivation of the proposed quality of supply allowances and release of the financial model by the end of July. We are encouraged by this improved transparency, which is essential to enable ongoing useful dialogue.

The remainder of this letter focuses on the key issues that we believe still need to be addressed; our detailed comments on the document are included in the attachment.

Creating The Climate For Investment

Although progress has been made, we still believe Ofgem has some way to go before it can claim to have created the climate for sustained network

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investment which is necessary for DNOs generally and for Central Networks in particular.

We believe Ofgem's Initial Proposals currently offer investors insufficient returns in a context of increased risk and negligible opportunities for out-performance.

For Central Networks the current proposals represent a future in which capex and opex allowances are too low, risks are increased, opportunities to gain from incentives are negligible and, as a result of all this, the high standards of service to our customers are threatened.

Over the coming months we will be doing everything in our power to ensure that the future for the customers of Central Networks is significantly improved.

Opex Allowances and Benchmarking

We believe that Ofgem's benchmarking process has serious flaws and is discriminatory to Central Networks and other DNOs which were single at the time of the analysis.

We repeat our concerns that Ofgem has in effect ignored our forecasts for opex and is relying instead on deriving opex allowances from a highly questionable analysis of historical data.

We believe the 2002/03 data sample used is too small and consequently that confidence in any analysis based solely on such data must be low. We also believe that Ofgem's attempt to normalise the data is not sufficiently robust and is unrepresentative of future costs.

Ofgem's preferred regression technique uses a simplistic composite scale variable, which is not sufficiently reflective of DNOs' cost drivers, and the regression technique itself produces results which have inherent uncertainties which Ofgem is choosing to ignore.

Although Ofgem makes a token gesture towards using alternative analyses as sense-checks of the results, we believe Ofgem continues to place too much reliance on a single analytical technique, ignoring the inconsistencies exposed by its own commissioned Ernst and Young reports, and omitting to use data envelopment analysis at all, despite earlier commitments to do so.

The result of Ofgem's flawed approach is to distort the apparent efficiency of the electricity distribution sector, and this is used as the basis for making dramatic cuts in DNOs' opex allowances. Then, with little justification and no questioning of their viability, Ofgem's proposals go on to expect all DNOs to reach the alleged "efficiency frontier" almost immediately and to increase ongoing productivity to 2010 well in excess of UK general productivity.

A number of companies has expressed concerns about the magnitude and sustainability of the proposed allowances and the TFP factor. We share these concerns and believe more account needs to be taken of our forecasts. As we have argued in previous papers and in recent meetings, Ofgem's justification for its approach is not sufficiently robust and will lead to unsustainable opex allowances. We suggest ways in which Ofgem might better proceed in our detailed response, and will continue to work with you to identify solutions within your benchmarking framework, but we do urge that more emphasis is placed on our submitted forward business plans

The Treatment of Mergers

We have made it very clear to you that this is a key issue for us. We believe that Ofgem's assertion that "savings achieved by merged DNOs are attainable through other corporate structures and not exclusive to mergers between DNOs" is false, and that we have demonstrated that there are savings which DNO-with-DNO mergers can capture, which are unavailable to DNOs which are merely part of a larger corporate group. As a consequence, we believe that, unless Ofgem adjusts its benchmarking analysis to reflect this error, the benchmarking will be fundamentally flawed, in terms of not comparing "like with like", and discriminatory against DNOs that were single at the time. That makes it unsafe for Ofgem to rely on the benchmarking as it presently stands.

Ofgem needs either to produce evidence to show that its assertion is correct, and Central Networks is wrong, or to change its position.

We set out our proposals for the merger adjustments we believe Ofgem should make in our detailed response.

Merger synergies require significant costs to achieve and we remain adamant that Ofgem must allow merger benefits to be retained for a full five years. Without this commitment, Central Networks will be exposed not only to the £32m merger tax, but also to losing the financial benefits of the synergies on which the investment was based. This would be contrary to

our legitimate expectations at the time of the Central Networks merger. The basis upon which the investment was made was that Central Networks would be allowed to retain merger efficiency savings for 5 years. This is in accordance with Ofgem's general policy on efficiency savings and consistent with its expressed policy on the relative treatment of merger and other types of savings as noted in the 2002 Merger Policy Document.

Capital Allowances

We are pleased with the progress in this area.

We welcome Ofgem's and PB Power's broad recognition that our investment plans are justified by rigorous cases for network need and Ofgem's proposal to allow us a sizeable proportion of our capital submission.

We are also pleased that Ofgem has now turned its attention to the DNO-preferred case and we will work with you proactively, as we firmly believe it represents better value for money for customers than the artificial construct of the base case.

There remain areas of difference, however, in particular the treatment of ESQCR-badged capex for Central Networks East, the exclusion of overhead line reconductoring and LV Consac cable in Central Networks West, and the general capital allowances proposed for quality of supply improvements, which are insufficient to deliver the proposed quality of supply targets. In addition we still believe there are good grounds for allowing us capex for resilience and "the environment" or visual amenity, and we will continue to advance our arguments in these areas over the coming months.

We are pleased that Ofgem has issued copies of the PB Power reports. These will enable us to validate and, of course, possibly challenge the justifications for reductions in our submitted allowances.

We look forward to ongoing constructive dialogue in this area.

Cost of Capital

It is generally agreed that there is a need for long-term, sustained investment in network assets to at least maintain existing standards of service and to facilitate the achievement of government targets for renewables by connecting distributed generation. It is also generally agreed that funding this investment is best achieved by attracting equity investors to the electricity distribution sector.

We contend that it is also generally agreed that Ofgem's proposed cost of capital, the prime means for attracting the necessary equity investment, is not yet attractive enough to achieve this outcome.

We believe Ofgem's proposed cost of capital takes insufficient account of the increased risks and reduced opportunities for out-performance which result from Ofgem's own general proposals for DNOs. It also takes insufficient account of financial markets generally, and of the cost of capital proposals in the UK water sector in particular. This is the sector which is the closest comparator to electricity distribution and will soon be competing for investment funds in debt and equity markets.

Importantly, there is evidence of general agreement with our view amongst key decision-makers in financial markets. These people are now expecting Ofgem's final proposal for cost of capital to be higher than that proposed so far, probably in line with the bottom of the range proposed in the water industry.

If Ofgem does not raise the cost of capital, equity investment will not be forthcoming, and the plans for asset replacement and renewal necessary to maintain current standards of service and connect distributed generation will be jeopardised.

We will work with you to ensure that any representations you receive from the markets are comprehensive and complete, since we do not recognise your view that analysts are broadly satisfied with your proposals for cost of capital.

Pensions

We welcome Ofgem's recognition that there is merit in our view that early retirement deficit contributions (ERDCs) were an efficient use of pension fund surplus, but we remain concerned about the progress on pensions.

We still hold that it is a basic principle of regulation that efficiently incurred costs and actions should be allowed and recoverable, and that the current price control was agreed in the full knowledge that restructuring and severance costs were materially not provided for, and that the pension surpluses were there and would (and legally must) be used. Reducing costs during the DR3 period has relied mainly on cutting jobs and the "protected persons" status of most employees has committed the DNOs to significant ERDCs. East Midlands was the first DNO to close its ESPS pension

scheme to new entrants, followed very closely by Midlands, which demonstrates the companies' commitment to efficient staff remuneration.

The costs of subsequent pension deficits were not foreseeable, but they are efficiently incurred, and while we seek no compensation for increased pension costs for this price control period, we must insist on them going forward. In this regard, we would point out that Ofgem has sufficient data to assess when each DNO had the benefit of reduced staff numbers through the surplus-funded use of ERDCs, and that there is consequently no need for Ofgem to make a standard or general approximation of benefit to DNOs and customers. We encourage Ofgem to use the data it has required DNOs to gather.

We look forward to further discussions with you on these important issues.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R Taylor', with a stylized flourish at the end.

Bob Taylor
Managing Director

Central Networks' Detailed Comments on Ofgem's Initial Proposals June 2004 Document

The following detailed comments are structured to follow the order and numbering of Ofgem's document.

3. Structure of the Price Control

3.5-3.7 Revenue Driver

Ofgem proposes that there will be no volume driver attached to EHV revenues.

As we said in our response to the March policy paper, we support Ofgem's proposals on EHV charges, believing that DNOs and Ofgem should seek to produce a robust driver during the next price control period.

Ofgem proposes revised weightings for the "tariff basket" unit drivers of the price control.

The revised weightings are "revenue neutral" and we therefore accept them as an interim measure for DPCR4. We continue to believe that work on the Structure of Charges will enable the weightings to be reviewed more thoroughly for DPCR5.

3.8-3.10 Price Index

Ofgem proposes to use the RPI for the next price control period.

As we said in our response to the March policy paper, we believe the right approach is to continue using RPI in DPCR4, but to consider changing to CPI in subsequent review periods, following a measured analysis of its implications, and we therefore support Ofgem's proposal.

3.12-3.14 Units Distributed Out of Area

Ofgem proposes that DNOs, which distribute units out of area, should be unable to charge domestic customers any more than the incumbent DNO. In addition, Ofgem proposes that such revenue should be treated as an excluded service item.

This seems to us a sensible approach and we support Ofgem's proposal.

3.16-3.17 Rates

Subject to review, Ofgem is not proposing to disallow rates costs.

As explained in our letter of 5th July to Carl Hetherington, Central Networks has secured a negotiated valuation that will result in a significantly lower rates burden for the DPCR4 period than for the DPCR3 period.

We believe we have now done everything that a comparable competitive firm would do to ensure that the VOA sets the appropriate rateable values, and that the rates costs for the DR4 period are 'uncontrollable'. Consequently, they should be recovered via a pass-through mechanism comparable to that for exit charges and the licence fee.

3.19 Revenue Protection

Ofgem is considering treating revenue protection as an excluded service and welcomes views on this.

As expressed in our letter of 24th June 2004 in response to the recent consultation, we believe DNOs are best placed to undertake this activity, and, subject to an appropriate cost recovery mechanism, we support this proposal.

3.22-3.27 Allocation of Costs for the Incentive Mechanisms

Ofgem proposes to treat all operating and capital costs on the same basis for the purpose of determining the incentive payments that companies receive for achieving efficiency savings from April 2005.

In May 2004, Ofgem published a letter on how it intended to equalise these incentives. Under this proposal, operating costs are added to the RAV but fully depreciated in the year they are incurred. Although this has a neutral effect on cash-flow, there is a significant impact upon the incentive properties of the price control.

Since privatisation, DNOs have successfully removed inherited inefficiencies, as demonstrated by the significant productivity improvements achieved during the 1990s and early part of the current price control. However the low-cost initiatives have been exhausted, and hence the payback period of up-front investment to deliver future productivity improvements becomes more important to assess.

The current regime is based on the assumption that 100% of incremental opex savings are retained by shareholders for five years. In the initial proposals, Ofgem proposes a sliding scale approach for setting the capex allowance, where depending on the DNO:PB Power ratio of capex forecasts, a marginal incentive rate is set. This incentive rate would presumably have to apply to opex in a regime where opex and capex sharing benefits were equalised, although it is far from clear to us as to how this proposal will operate, and hence impossible to undertake cost-benefit analysis of incremental efficiency saving initiatives. We trust this will be urgently addressed over the next few weeks, and we would be grateful if further details were announced prior to the September update paper, for instance, via the incentives working group.

Figure 3.1 below has assumed for illustrative purposes that the marginal incentive rate is derived on an NPV basis. It compares the current approach to opex with the equalisation of opex and capex as set out in the May 2004 letter, using a number of NPV benefits; 35%, 50% and 75%.

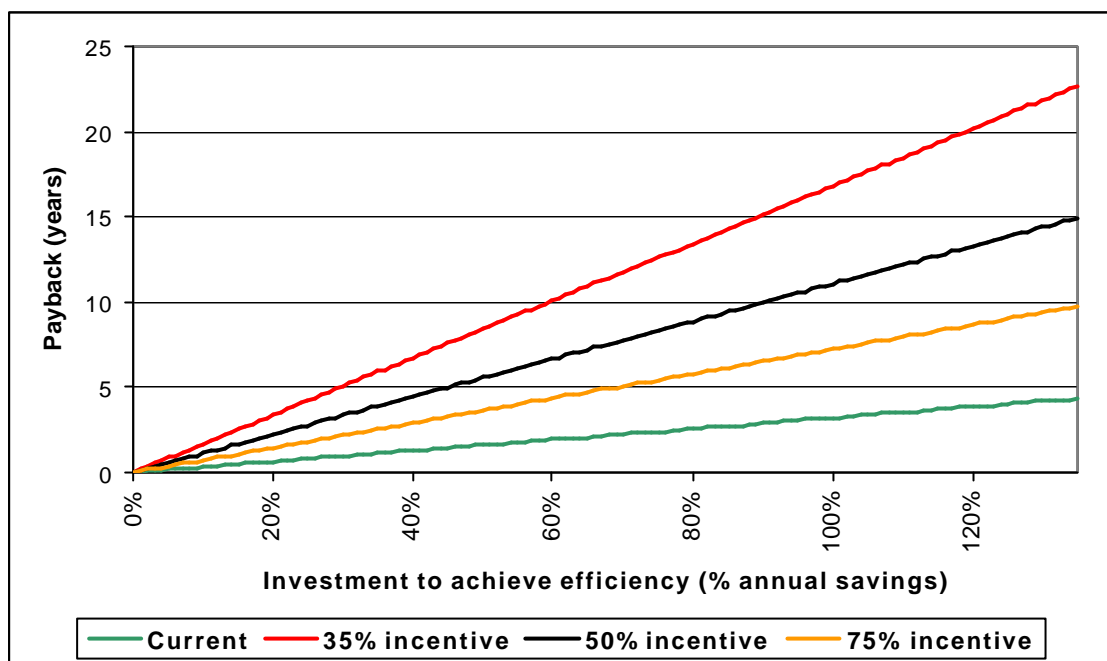


Figure 3.1 Payback periods under different benefit arrangements

The implication of imposing a 35% marginal incentive rate on Central Networks for operating cost efficiencies is to significantly reduce the viable number of efficiency initiatives, which we do not believe is in the best interests of customers. Whilst the current approach allows up-front investment of around 150% of the annual benefits to be initiated, Ofgem’s proposals would reduce this figure substantially to 30%. If these proposals are not re-thought, ongoing productivity within the industry will be adversely affected, which must be reflected in any assumptions of opex for the next price control.

If the marginal incentive rate is increased to 50%, this would raise the number of viable efficiency projects available. However, it would still result in many projects being discarded on a cost-benefit basis, suggesting a very high marginal incentive rate is required to close this gap in order to protect the interest of future as well as existing customers.

This intention must be considered alongside Ofgem’s proposals for setting opex allowances in DR4. Compared to DR3, the proposed cost allowance is far more aggressive in providing a greater balance of present and future savings to customers. To also now propose a weakening of the benefits from any out-performance significantly changes the price control from that which companies currently operate under.

We therefore do not accept that the proposal to equalise the marginal incentive rates for opex and capex is in the best interests of either shareholders or customers.

One of the problems concerning data collection during this current review has been the degree of ‘normalisation’ required to make comparisons. The burden on both companies and Ofgem can however be greatly reduced by having more clearly defined regulatory accounting guidelines, thus providing more consistent data. This would allow for clear boundaries between opex and capex definitions which could be enforced, and thus permit differential incentives, which protect the longer term interests of customers. We believe there is sufficient time between now and the next price control to introduce such

prescriptive RAG definitions, especially if the rewards from efficiency gains are not realised until the end of DPCR 4.

Alternatively individual companies could agree definitions with Ofgem to address the Ofgem concern of post price review accounting changes. These bilateral agreements would allow the individual company access to the previous opex incentive process while allowing more time for a common approach to be developed.

3.28-3.34 Dealing With Uncertainty

Ofgem proposes re-openers for "lane rentals" and ESQCR, committing to a licence modification for lane rentals, which will allow costs to be considered in isolation, and proposing a limited re-opener for ESQCR following the planned consultation at the end of this year. Ofgem also proposes a further re-opener on ESQCR in 2008 to consider costs associated with line clearance work.

We welcome Ofgem's recognition of the significant uncertainties posed by lane rentals and ESQCR and broadly support the measures proposed and the intention to assess such costs in isolation of financial performance. Our support is qualified though because of the time-bounds set on ESQCR. Rather than commit to a review in 2008, we believe any review should occur once ESQCR costs start being incurred.

We would also point out that there remains considerable uncertainty regarding the future tax position of distribution companies. The change in treatment of deferred revenue expenditure is not the only change that could affect the industry. The Inland Revenue is currently considering various proposals for the reform of the corporation tax system. One of the potential reforms is the modernisation of the capital allowances regime to reflect more closely the relative economic value of different forms of investment. Depending on what form the modernisation takes, this could have the effect of further increasing tax liabilities for distribution companies.

We believe uncertainty of this magnitude warrants treating these tax costs similar to lane rentals and ESQCR and urge Ofgem to do so.

3.35-3.45 Losses

Ofgem confirms its previously announced proposals on the form and structure of the losses incentive scheme.

We repeat here the position we laid out in our letter of 21st May. Central Networks supports the overall design of the new losses incentive framework, which has shifted away from a moving average target to a five year fixed target.

However, we do not see any need for transitional arrangements between the two incentive regimes. We acknowledge that there will be initial differences in the rewards or penalties faced by individual DNOs, but believe these will generally be small and are only to be expected when an important incentive is improved. Transitional arrangements would inevitably have the effect of 'watering down' the incentive, and might reduce DNOs' efforts to reduce losses.

Furthermore, since the proposal to strengthen the losses incentive was first made there has been a perverse incentive for DNOs to delay loss-reducing investment, thereby saving on capex and increasing their fixed losses target for DPCR4. Any transitional arrangements would further reward such behaviour, and conversely, would penalise DNOs that have undertaken successful loss reduction initiatives in the DPCR3 period.

Notwithstanding the above, if Ofgem still believes transitional arrangements are appropriate, we believe these should apply only to those DNOs (if any) that would be materially disadvantaged by the new arrangements.

If, however, Ofgem wants to adopt the same transitional arrangements for all DNOs, a possible way forward is to reduce the weight of actual losses performance over the 1998-2004 period from 100% to 70% to address the uncertainty regarding the settlement system in setting DPCR 4 losses targets.

[Ofgem proposes a value of £48/MWh as the incentive rate for losses.](#)

We recognise the difficulties in estimating the value of losses and believe Ofgem's approach and analysis are both sensible and fair; we support Ofgem's proposed incentive rate.

3.46-3.72 Metering

Progress on the metering price control is less advanced than other areas, and we are engaged in a continuing dialogue with Ofgem to develop both parties' understanding. The following paragraphs contain our provisional thoughts, which we expect to evolve over the coming months.

3.50-3.53 Structure of Control

3.50 MAP

[Ofgem is proposing a price cap for the provision of certain types of meters and a licence condition requiring DNOs to use a non-discriminatory approach to calculate price capped and non-price capped charges.](#)

We support the principle proposed for the structure of control for Meter Asset Provision. Price caps produce the simplest and most transparent form of price control. We are concerned however, that the price caps will be based on the current cost of meters and will not be varied with the quantity of meters provided. The costs of meters inevitably reflect the volumes being purchased, and as DNOs lose market share, they will no longer be able to negotiate such low-cost contracts with manufacturers.

3.51-3.53 MOP

[Ofgem is proposing a transitional approach, using an average revenue cap where revenues are limited by an amount related to the number of meters provided.](#)

[Ofgem welcomes views on whether DNOs should recover the fixed costs associated with lost market share through their remaining MOP market share.](#)

We believe that Ofgem is considering the wrong option for the MOP price control. The current proposal for an average revenue cap will lead to a complex mechanism, incapable of accurately reflecting the significant fluctuations in annual volumes of work that occur in meter operations. Ofgem clearly has a difficulty in identifying drivers for the average revenue cap and has not yet been able to present proposals on how such a control may operate in practice (e.g. with regards to over and under recoveries etc.). Certainly the approach of linking revenues to numbers of meters only is unacceptable, for as Ofgem has already recognised, direct costs can vary by as much as 50% from year to year on the same asset base, and many of the activities undertaken are at the behest of suppliers and are therefore not determined by the DNO e.g. change of meter on change of tariff.

We propose that the price control should be based on price caps similar to those proposed for MAP (i.e. 2 price caps with a non-discriminatory approach to calculate other prices). As DNOs lose market share such price caps could be adjusted in a similar way to that currently proposed i.e. by increasing the overhead recovery element in the pricing calculation in such a way to reflect the cost structure discussed in 3.64. This approach will be simple to implement, transparent to all market participants and simple to operate for both DNOs and Ofgem.

We note Ofgem's proposed approach to the recovery of fixed costs. However, we do not accept that competitive markets would enable DNOs to recover these costs incurred in meeting their licence obligations through a separate metering price control. Consequently we believe a mechanism is required to recover such costs through the distribution price control.

3.54-3.60 Indicative Numbers – MAP

[Ofgem proposes price caps for standard domestic and prepayment meters.](#)

The proposed specific price caps for MAP appear to be low, but until Ofgem provides the detailed models we remain unable to reconcile them to our costs. We also believe that any price caps should more closely reflect the actual costs of the meters and that the proposed charges should be more consistent across DNOs than the published table currently indicates.

Ofgem has stated that in determining the price caps the current expected life of the meter has been used (with no adjustments for the impact of competition and early asset removal). This will leave significant value at risk when loss of market share makes it impossible to re-use meters removed from the wall before the end of their useful lives. This risk is potentially much greater for prepayment meters where, as Ofgem recognises in Paragraph 3.56, suppliers are looking to introduce different technology, making the current meters redundant. The investment in these meters, made as a result of the licence obligations, must be recoverable.

There are a number of options which would allow the DNOs to recover such investment:

1. The simplest approach, which Central Networks believes provides sufficient protection of the investment made by DNOs and minimises charges to customers, is for Ofgem to allow the DNOs to charge termination fees for early removal of meters. This would fit well with the current proposals – price caps based on expected lives and termination payments calculated on a non-discriminatory basis for early removal.
2. The price caps could be based on a lower expected life, e.g. half of that currently proposed. DNOs would then be allowed to charge at the level of the price cap or could offer contracts to suppliers with lower charges combined with termination charges.
3. Use a higher rate of return to compensate for the early terminations and market risk. Central Networks prefers options 1 and 2 as the rate of return required to compensate for such risk would need to be extremely high.

3.61-3.64 Indicative Numbers – MOP

[Ofgem shows metering opex and numbers of meters for each DNO and notes it will be working with DNOs before finalising proposals.](#)

Table 3.4 is misleading as it sets out the opex metering costs of the DNOs and not total MOP. It does not recognise that historically some MOP costs have been capitalised (with DNOs having different policies) and that the opex numbers may also include some MAP costs. The values in this table must not be used to formulate any price controls as they will lead to substantial under-recovery and unacceptable variations in prices across DNOs.

Ofgem needs to set the right margins for MOP services (paragraph 3.63) to ensure the price control allows competition to flourish without distortion. Such margins should be set at a competitive market level rather than that associated with a relatively risk-free regulated business.

3.65-3.72 Associated Charges – Standard Licence Conditions 36-36C

Basic Services

Ofgem is proposing to change the obligation so that the DNOs are only obliged to provide “basic” metering services.

The proposed approach of limiting the licence obligations to a ‘basic’ meter service is supported by Central Networks. However, tying this back to services offered by individual DNOs up to 2 years before the start of the price control will only lead to a confused situation which is difficult to monitor. Furthermore, it will not allow suppliers to easily compare prices and services across regions. The ‘basic’ metering service should therefore be standardised across all DNOs and reflect the minimum acceptable level of service e.g. not including short notice appointments / out of hours etc.

However, if a reference date is to be used, we believe that the proposed date (1 April 2003) is incorrect. This date was before the separation of MAP and MOP and the implementation of REMA. We believe that a more appropriate date would be after 1 June 2003.

One Way Door

Ofgem is proposing to modify the obligation to provide a metering service so that it no longer applies to suppliers who have decided to take services from metering service providers other than the DNO.

We welcome the introduction of this proposal, as it will enable DNOs to restructure their resources and strategy to reflect any loss of market share. Detailed work needs to be undertaken to establish how this will operate in practice.

Long-term Switch-off

Ofgem is proposing to switch off the provisions of SLC 36-36C as they relate to meter operation and the provision of new metering assets with effect from 1 April 2007.

Central Networks agrees with the proposal to remove licence obligations by 1 April 2007. By that stage many DNOs are likely to have lost significantly more than 50% market share. We also agree that there is a need to retain obligations for MAP services relating to existing assets provided by the DNOs at that date. However, after 1 April 2007 DNOs should have no further obligations with regard to MOP services on all meters.

4. Quality of Service

Our response to the chapter on quality of supply and other outputs also includes our comments with respect to quality of service issues and analysis outlined in Appendix E – The losses incentive and quality of service.

For clarity we state again the general principles which inform our thinking on quality of supply:

- Because networks will always be subject to events that result in customer outages, delivery of quality of supply (QoS) is best achieved through a network which is *generally* more reliable and which minimises the number of customers affected.
- For the purposes of network performance we do not believe in discriminating between different groups of customers except in terms of network characteristics. Quite apart from our obligation not to discriminate, the network itself “does not readily distinguish” between customer groups.
- Distinctions between customer groups can be made for the purposes of more general, non-network services, but there must be robust and compelling grounds for making such distinctions.

We believe these principles are largely realised in the current framework of GS for individual customers, IIP for overall performance and licence conditions for specific obligations.

We also continue to believe that Ofgem and the DNOs, in conjunction with the DTI, need to make societal judgements and decisions on longer-term aspirations such as sustainable network performance, improved network storm resilience and environmental aspirations. We comment further on these aspects in the relevant sections, but are pleased that Ofgem is now engaging in discussions on these matters.

We continue to participate in the Ofgem / DNO Quality of Supply Working Group (QoS WG) to discuss and influence the format of the quality of service and other outputs from the network. Indeed, in certain areas the proposals in this section have benefited from the work of the group. However, the interaction of some of the proposals, particularly under severe weather conditions, needs developing further. In addition, some of the recently developed proposals such as the weighting between planned and unplanned interruptions, how to reward “frontier” companies, the derivation of capex and opex allowances for CI and CML improvements, CML target setting and customer compensation need to be exposed to a more rigorous debate through the forum of the group. We therefore support ongoing dialogue with Ofgem through the QoS WG.

Our detailed views on the current proposals follow. In summary however we consider that:

- Incident duration is not simply opex-driven as assumed in the proposals. It depends too on inherent network characteristics such as location and the existence of alternative feeds and can be improved by capex initiatives, such as remote control.
- The methodology used to derive the QoS targets, specifically those for CMLs, has changed significantly from that used to set the QoS scenario targets e.g. the use of upper quartile CML / CI benchmark to derive CMLs from the CI benchmarked performance rather than the separate identification of CML benchmarks as proposed by the joint Ofgem / DNO QoS WG.
- We believe the proposed targets are unfair and inconsistent with the proposed allowances for both opex and capex.

- The use of upper quartile performance severely restricts the practical range of the symmetrical incentive scheme, effectively resulting in there being little probability of DNOs achieving rewards. We suggest using average performance to set CML targets, allowing the incentive to drive further improvements
- Given the currently proposed opex and capex allowances, the expectation that CML/CI benchmarks can be delivered by 2010 is unrealistic. Therefore we propose that benchmark performance should be based on 2020, with 2010 targets derived from a glide path delivery as per CI, with the “preferred” capex allowance.
- Very severe exceptional events as identified by 50% of customers impacted on mixed/rural circuits is too onerous and we suggest that 25% of total customers is a more reasonable threshold

4.3-4.6 Summary of Results from the Consumer Survey

Ofgem summarises the results, saying they are indicative not definitive, but do point towards a willingness to pay which could be reflected in stronger incentives for improvements in quality of supply, provision of information and restoration of supplies.

The table below is a summary of the results from the domestic part of the survey and shows how much customers are prepared to pay in addition to their current bill.

SUMMARY OF DOMESTIC CONSUMERS’ WILLINGNESS TO PAY

Potential Improvement	Increase in Current (Supply) Bill Willing To Pay (%)	Approximate £s
24 hour restoration in severe weather	6.0	£21.80
Info update every 2 hrs in severe weather	6.0	£21.80
Reduce “normal” cuts by 20 mins	6.0	£21.80
36 hour restoration in severe weather	4.4	£16.00
Reduce unplanned urban cuts	4.0	£14.50
Reduce major “storm” cuts to 1 every 5 yrs	3.9	£14.20
Helpline	2.9	£10.50
Automatic compensation for all standards	1.5	£5.40
Reduce unplanned rural cuts	1.2	£4.40
Undergrounding per % network	0.7	£2.50

Ofgem concludes, rightly in our view, that the results provide clear demonstration that customers’ priorities are related more to restoration of supply than anything else.

However, as the highlighted rows show, the table also demonstrates that customers are willing to pay for other things, resilience and undergrounding amongst them, and, by reducing DNOs’ proposed capex allowances by any expenditure related to resilience and the environment, Ofgem has effectively ignored this. The WTP survey is indicative of customers’ preferences and, by refusing to allow expenditure on resilience and undergrounding, Ofgem is effectively stopping DNOs from delivering what customers want.

We comment further on resilience and undergrounding in the relevant sections below.

4.7-4.8 Revenue Exposure to Quality of Service Incentives

Ofgem proposes to increase revenue exposure as follows:

Incentive Arrangement	Current Exposure	Proposed Exposure
Interruption incentive scheme	2% to -1.75%	+/- 3%
Storm compensation arrangements	- 1%	- 2%
Other standards of performance	Uncapped	Uncapped
Quality of telephone response	+/- 0.125%	+0.05% to -0.25%
Quality of telephone response in storm conditions	Not applicable	0 initially +/-0.25% for 3 yrs
Discretionary reward scheme	Not applicable	Up to +£1m
Overall cap/total	+2% to 2.875%	4% on downside No cap on upside

The introduction of new and revised incentives introduces risk into the distribution business that is difficult to quantify at this stage because there is little definitive information on how to judge the degree of uncertainty, in particular:

- the allowances that underpin both the base case and QoS targets do not have a robust linkage to the targets;
- the precise details and operation of the exceptional event exclusion mechanism are still to be refined and agreed;
- the capping mechanism appears inconsistent with the use of annually derived caps when the regulatory perspective is a 5 year horizon. We comment further on this aspect in our response to the Regulatory Impact Assessment

Overall though, we contend that these proposals represent significant increases in risk for DNOs, which, along with reduced opportunities to out-perform on opex and capex incentives, justify a higher cost of capital than Ofgem is currently proposing.

4.9-4.23 Standards of Performance

4.16 Severe Weather Standard

There will be separate standards for restoration under “normal” and “severe” weather conditions set out in a new licence condition. The existing 18-hour threshold and levels of compensation will be retained under normal weather conditions.

The principle of a GS is that it should set minimum standards that are attainable, and that the standard should allow an efficient DNO to be capable of avoiding payments for failure both during normal and severe weather conditions. The “normal” weather element of GS2 has served customers well whilst at the same time acknowledging in part the limitations imposed on restoration by network design and safe restoration practices. We comment further on the proposed severe weather arrangements in the storm payments arrangements section.

However, the proposed severe weather arrangements and their thresholds are based on working assumptions that are yet to be tested fully in practice. Consequently, we believe that there needs to be a degree of flexibility to allow these to be adjusted, if necessary, in the light of experience.

4.17-4.18 Semi-automatic Payments

Ofgem retains its commitment to ensuring that penalties on DNOs under the 18 hour restoration standard or severe weather arrangements are the same, whether or not the consumer claims (i.e. where they do not pay the consumer the company will face an

equivalent reduction in price control revenue). Ofgem proposes allowances to cover efficient costs.

Central Networks is willing to support the proposal for semi-automatic payments, but under “normal” weather conditions only.

As we have said in previous responses semi-automatic payment is feasible under normal weather conditions because on-site checks can usually be made of the affected customers by the restoration teams.

On-site checking is not feasible during the level of incidents implied by a “severe” event. Identification in these circumstances is totally dependent on the accuracy of the customer connectivity models. HV connectivity is well defined, but at LV we are unable to identify phase connectivity, it is not maintained in real time, and it is not subject to the same operational regime.

The consequence of this is that we are unable to accurately identify all affected customers during a severe event and Ofgem’s proposal will result in some customers (or their suppliers) unaffected by the event receiving payment and some affected customers not receiving payment at all.

We therefore support the concept of semi-automatic payments, but for GS2 during normal weather conditions only, using on-site validation of the customers involved. This fits with our principles of good customer service practice and is similar to the *ex-gratia* scheme we presently operate for this restoration standard. We believe semi-automatic payment should be limited in this way on the grounds of practicality, efficiency and service-priority. Under other weather conditions customers should be made aware of the circumstances under which they can claim but they should make any claim themselves if affected.

Central Networks welcomes Ofgem’s recognition of the need to allow efficient costs, but we would point out that this is not simply a matter of allowing recovery of payments made. DNOs also need opex to reduce the level of GS failures – e.g. use of generators and capex to improve the network such that the causes of GS failures reduce.

4.19-4.21 Route for Payments to Consumers

Ofgem proposes that DNOs should have the option of making payments directly to consumers, although there should still be the alternative of making payments via suppliers where this is not practicable.

Ofgem was responsible for defining the supplier hub principle and we believe that this is fundamentally an Ofgem policy decision. This proposal requires further development, including proper consideration of the relevant incremental costs and benefits. We believe this would be most appropriately carried out through an industry-wide forum.

4.20-4.21 Compensation for HV-connected Business Customers

Ofgem proposes to retain the existing arrangements.

Central Networks supports this proposal.

4.22 Overall Standards of Performance

Ofgem proposes to replace some and enhance other OSs with monitoring and publication under IIP.

We support the replacement of the Overall Standards, including their thresholds, by the collection of similar, and in certain instances, enhanced data under the IIP regime. If we are to maintain data quality, we consider that it will be necessary to extend the data timescales prescribed in the licence, especially when the provision of disaggregated network performance data for QoS purposes is taken into account. We believe extending the timescale by a month, from the end of April to the end of May would still be appropriate.

4.23–4.55 Interruptions Incentive Scheme

4.32–4.34 Form of the Incentive Scheme

Ofgem proposes to modify the incentive scheme for interruptions by:

- introducing symmetric annual rewards and penalties depending on performance against targets with the impact of severe weather events being fully excluded from the scheme
- introducing reward/penalty bands of 25% either side of CI target and 30% either side of the CML target
- increasing the revenue exposed to 1.2% for CIs and 1.8% on CMLs
- applying a 50% weighting to planned interruptions (changed from 100% under the current scheme)

We note Ofgem's proposals to introduce an incentive scheme with symmetric annual rewards and penalties. We have a number of detailed concerns with the proposed scheme:

- We are still concerned that the network performance data on which all analysis and assumptions have been made is heavily dependent on just 3 years of RIG compliant data.
- This time horizon will not adequately capture the inherent variability of network performance – even a 5-year regulatory period is insufficient to ensure a statistically robust judgement of network performance.
- There is no visibility of how the rewards and penalties mechanism will work in practice.
- There is no transparent linkage between the target setting process and the proposed financial allowances.
- Ofgem has effectively ignored the submissions made by DNOs on QoS.
- Ofgem proposes excluding only the impact of severe weather events, whereas all exceptional events need to be excluded from the incentive scheme.
- Whilst we welcome Ofgem's acceptance of the differing customer impacts of unplanned and planned interruptions, the overall CI and CML targets must be set in relation to a DNO's capex allowance, to prevent dilution of the drivers that encourage investment.

4.35–4.39 Setting Targets – Number of Interruptions

Ofgem has applied a 0.5% per annum improvement in the benchmarks for the number of customers interrupted through to 2020 to reflect developments in technology and best practice.

If a company is already outperforming the 2020 benchmark calculated on this basis, proposed targets are set in line with current performance. If a company's average performance is worse than its 2020 benchmark, proposed targets are based on catch-up of 40 per cent of the performance gap by 2010, provided that the improvements can be achieved at reasonable cost.

Ofgem proposes targets based upon disaggregation and benchmarking, summarised as follows:

- Unplanned LV benchmarks are based upon an average of recent (02-03 and 03-04) performance.
- Unplanned HV benchmarks are based upon an average of recent (02-03 and 03-04) disaggregation benchmarks
- Unplanned EHV and 132 benchmarks are based upon 10 year average performance.
- The sum of the individual benchmarks is used as a starting point for 17 years of annual 0.5% improvements to 2020.
- Where a DNOs 3 year recent average outperforms the 2020 target the 2010 unplanned target is set to the 3 year average. Where the DNOs average performance is worse than the 2020 target the 2010 unplanned target is set to the 3 year average less 40% of the difference.
- In a limited number of cases, certain DNOs can only achieve the 2010 unplanned targets through disproportionate capital investment and have therefore been set easier unplanned targets.
- An allowance has been made for planned interruptions where the values are based upon analysis of historic levels and capital expenditure.
- Overall 2010 targets including planned are compared against 3 year recent performance including planned and the lower of the values is used as the 2010 target.

Capital allowances are then based upon the difference between 3 year average performance and the 2010 benchmarks, and the marginal cost of improvement

Whilst we support the disaggregation approach to setting longer-term targets, the targets need to be directly and transparently related to the investment required to deliver performance improvements. Before we can support any targets we require visibility of the entire target-setting approach for both our own companies and other DNOs so that we can understand:

- the viability of the targets proposed and the supporting financial allowances
- the derivation of planned interruption “allowances”
- the determination of marginal costs of improvements including the disproportionate costs issue

4.40–4.42 Setting Targets – Duration of Interruptions

Ofgem has calculated benchmarks for average restoration times based on:

- average performance across companies at low voltage;
- upper quartile performance at high voltage; and
- an average of the companies’ own performance at EHV and 132 kV.

Ofgem proposes to apply these benchmarks to the targeted number of interruptions to derive the 2010 targets for customer minutes lost.

Ofgem proposes targets for CML based upon a benchmarking duration methodology, which can be summarised as follows:

- Unplanned LV CML benchmarks are based upon 2-year average CI multiplied by a benchmark duration derived by comparing 2-year average duration against an all DNO average of 3-year average duration. The benchmark duration is either the all DNO average or the all DNO average + 75% of the difference, where the 2- year average is higher.
- Unplanned HV CML benchmarks are based upon HV disaggregation CI benchmarks adjusted to 2010 CI values multiplied by duration benchmarks based upon a 2 year average quartile value derived from circuit type disaggregation.
- Unplanned EHV and 132 CML benchmarks are based upon 10 year average CI multiplied by recent 3 year average duration.

- The sum of the individual CML benchmarks is then combined to determine an overall unplanned CML 2010 target.
- An allowance is then made for planned interruptions with values based upon analysis of historic levels and capital expenditure.
- Overall 2010 targets including planned are then compared against 3 year recent performance including planned and the lower of the values is used as the 2010 target.
- Opex allowances are then derived which are not tied to the improvements required. Instead an improvement figure of £213 per fault is used to determine the value of opex required to reduce duration, with the figure being supplied by only one DNO.

Central Networks has significant unresolved concerns with both the targets proposed and the methodology used.

We do not support the use of average interruption restoration time as the sole driver of customer minutes lost. Work carried out by the Ofgem QoS group has identified that other network factors such as fault rates and customers interrupted per fault also contribute. We believe that the benchmark process adopted for the number of interruptions should also be used for CML, where benchmark values are used to determine 17 years of improvements to 2020.

The approach used for setting CML targets in the proposals has resulted in significantly tougher targets for both CN West and CN East when compared to those derived for the Forecast Business Plan Questionnaire (FBPQ).

The targets calculated for the FBPQ were based upon deriving a current benchmark value for CML and determining a 2020 target based upon 17 years of 0.5% annual improvements against the benchmark. The 2010 target was then calculated as current average performance less 40% of the difference between current average and the 2020 target.

The CML targets calculated in the June Proposals are based upon the product of 2010 target CI and either average CML/CI for LV and EHV or quartile CML/CI for HV.

The significant difference between the processes is that the June proposals expect benchmark duration performance by 2010, whereas in the FBPQ benchmark performance was expected in 2020. This change in methodology results in unplanned CML targets for CN West moving from 86.9 to 81.0 CML, and those for CN East from 75.7 to 63.3 CML.

Business plans have been developed to deliver benchmark performance by 2020 as required by the FBPQ. The reduction in time-scale to deliver this improvement by 2010 for CML significantly increases the risk of failure. It is therefore more pragmatic to base the targets on achieving benchmark performance by 2020 and allowing the incentive mechanisms to drive further improvements.

Furthermore, there is no connection between the required improvements and the proposed expenditure allowances, which provide insufficient revenue to deliver the benchmarked performance. We cannot support the methodology here for determining allowances and challenge strongly the validity of using information from one DNO alone. Such an approach fails to take into account the various inherent network factors of DNOs, such as: the degree of remote control; the loading and interconnection of different network configurations and; the different degrees of flexibility of operating resource across networks, depending on network configuration, for instance, skills are not readily transferable between OH and UG networks

4.45 Rewarding Best Practice

Ofgem proposes that WPD – South West and South Wales - should each be given an additional reward of 1% of revenue per annum to reflect having achieved very good levels of average restoration times during the current price control period.

In principle we support the introduction of a reward for best practice, for example for restoration performance. However, in the interests of fairness and to give all DNOs the opportunity to change their behaviours and practices, it is imperative that both the areas to be rewarded and the targets to be achieved are communicated to all participants in advance. Consequently, it is impossible to support this retrospectively.

4.46–4.50 Setting Incentive Rates

Ofgem proposes setting incentive rates based upon bands of 25% either side of CI targets and 30% either side of CML targets. These bands in combination with the increased exposure to rewards and penalties of 3% of revenue determine the incentive rate per CI or CML.

This proposal has been introduced at a relatively late stage in the consultation process without any previous introduction or discussion. The neutral point of the proposed QoS targets already incorporates significant improvements. The suggestion that a further 30% improvement can be driven by the incentive regime rewards is untenable, and we therefore cannot support this proposal.

4.51–4.53 Audits and Adjusting Data for Inaccuracy

Ofgem proposes to adjust each DNO's data to take account any inaccuracy identified by the audit. Ofgem also propose to tighten the overall accuracy requirements for 95% to 97% over the next price control period

We support the continued application of external audits, specifically the streamlined versions, for the next price control to maintain continuing improvements to consistency and RIG compliance across DNOs.

With respect to the adjustment for inaccuracies, we support in principle the correction to bring all DNOs to a nominal 100% accuracy level. However, any adjustment that is made needs to be treated against the background of confidence levels and a process that utilises a statistical sample to judge the accuracy of the whole population of incidents.

The adoption of a proposed 97% accuracy standard, as a licence condition, appears at odds with the desire to streamline the audits and possibly in the long term move to random audits. In our opinion the confidence limits would need to be tightened to give any assurance that the 97% was “really” being achieved. This would require an increased sample which is not cost justifiable. Consequently we would propose that the current accuracy requirement of 95% remains.

4.54–4.55 Frontier Performance for this Price Control Period

Ofgem proposes that the top 4 performers on CI will be eligible to take part in the CI element of the out-performance scheme. The top 4 performers on CML / CI will be eligible to take part in the CML element of the out-performance scheme

In principle we support a proposal that allows one or even more DNOs to secure a final year reward for which they may not be otherwise eligible. However, the proposal is outlined only, and we require further details and clarity of the mechanism before judging its practical merits.

4.56–4.62 Storm Arrangements and Network Resilience

Ofgem proposes to retain arrangements similar to the existing interim arrangements, but with several key amendments:

- simplifying the “gates” for exceptionality so that they are based on the number of faults in a 24-hour period. This removes perverse incentives to increase the number of customers affected to qualify for the arrangements;
- introducing a shorter threshold for payments of 24 hours for “medium-sized” wind and snow events and all lightning events;
- revising the gate for “very large” severe weather events to 50 per cent of consumers on mixed or overhead circuits (i.e. those consumers that may be affected by a severe weather event); and
- raising the cap on the distribution companies’ exposure to 2 per cent of price control revenue and removing the cost pass-through.

Ofgem proposes to allow an annual cost allowance for exceptional events to cover an efficient level of compensation payments and fault costs relating to the events.

Ofgem will reconsider large expenditure plans for network resilience if companies provide appropriate justification, including, in particular, an explanation of how this expenditure would provide value for money for consumers.

4.60 Storm arrangements - Restoration incentives following a severe weather event

Ofgem has indicated that it is appropriate to have incentives in this area and proposes to modify the interim arrangements associated with GS2 for the restoration of supplies following severe weather.

We are supportive of the tiered approach in relation to severe events, and welcome the retention of discretion for “very large” weather events. However we believe that further work is necessary in this area to understand the nature of very large events and suggest that in the interim a value of 25% of a DNO’s customers should be retained. This approach would also be more transparent to customers.

In order to ensure simplicity of the approach to customers, we would caution against the establishment of numerous payment thresholds. As we said in our response to the December 2003 document, the interim arrangements themselves are relatively new and the clarity they bring has been welcomed. We believe we should give the interim arrangements a chance to prove themselves in practice before considering whether they should be modified. Otherwise we are liable to be forever chasing weather events rather than establishing a certain and effective framework.

It is also unclear just how the proposed revenue cap will work in practice. In particular if in any given year there are a number of incidents that overall generate a requirement to pay compensation to customers greater than the cap how are the companies allowed to pass through the subsequent costs.

We also note that the proposed thresholds do not yet prevent the risk of multiple-jeopardy, as performance of DNOs could be still assessed both under the GS storm mechanism and the IIP. We believe, as a fundamental principle, that the arrangements for DPCR4 should not permit a DNO to suffer multiple penalties for the same event. Consequently, we believe that *force majeure* rules should be developed to ensure that any severe event incentivised under the GS storm regimes should be excluded from the IIP. The QoS WG is a suitable forum in which the interdependencies between an IIP *force majeure* event and the “storm” GS2 thresholds can be explored. In particular, the current IIP materiality test, which has an element of perversity, and the subjectivity

inherent in the mitigating-actions-test are areas for evaluation. There are no proposals yet made to adjust the force majeure tests of the IIP into DPCR4

We remain concerned that the storm proposals will end up as a compensatory mechanism rather than a standard to be achieved. To avoid this, the interim level of capping of financial exposure should be maintained, and an efficient level of cost recovery should underpin it. In the absence of additional investment for network resilience, the underlying interruptions to customers during severe weather events will remain at present levels.

4.62 Network resilience

Ofgem indicates that companies have not yet provided sufficient justification for network resilience improvements and therefore no allowance has been made. Ofgem says it will reconsider plans if companies explain how the expenditure provides value for money.

For the foreseeable future, and this may extend beyond DPCR5, the majority of investment in the network to improve storm resilience will only be quantifiable in terms of delivery of inputs, such as the replacement of certain assets. These need to be used alongside established output measures and value for money considerations.

It needs to be recognised that network resilience work can be expensive to address, and that, in the short-term, quantifiable benefits can appear to be minimal. However, we believe that the commencement of such investment is justifiable so that we can begin to change inherent network characteristics with the aim of achieving a distribution network that is capable of serving the needs of future customers. We still consider that Ofgem and the DNOs, in conjunction with the DTI, need to make societal decisions in order to shape the future direction of the networks.

We believe:

1. Ofgem is ignoring the steer given by the Trade and Industry Select Committee, which believed it prudent to build extra resilience into the system and expected Ofgem to reflect this when setting revenue controls;
2. Ofgem is ignoring the findings of the WTP survey and so is ignoring the interests of customers;
3. By concentrating on the “base case”, Ofgem runs the risk of ignoring our plans for spending on resilience, which we contend do represent good “value for money”. We note that Ofgem has now asked for further justification for the selective and targeted resilience plans that Central Networks has proposed. We will now engage positively with Ofgem to try and persuade them of the value of our proposals to our customers, both present and future.

4.63–4.70 Incentives for Telephone Response

Ofgem proposes to simplify the arrangements, with companies subject to a sliding-scale penalty if annual performance deteriorates below the current minimum average performance level (which is 4.1). If scores fall below 3.6, companies will be liable for the full penalty of 0.25% of revenue. Ofgem also proposes a small reward of 0.05% of revenue for those companies with annual mean scores higher than 4.5.

We are concerned that the incentives are not symmetrical and that the revised scheme effectively penalises investment made in telephone systems going forward. Also, any changes to either the question content or scope of the survey potentially affect the validity of the absolute scores of the “floor” and “ceiling”.

Ofgem will continue to look to broaden the scheme (possibly to extend the scope in 2007) to include those customers that received a message. Ofgem proposes to retain the

existing assessed survey questions, but also incorporate consumer satisfaction with the speed of telephone response.

We support the principle and believe there is value in expanding the survey to include customers who have listened to an automated message, but there remain issues with its practical development and implementation. Ofgem's proposal not to introduce the change immediately and to work further with the companies is therefore welcomed. To reiterate, our concerns are as follows:

- The possibility of some consumers being included in the survey twice. Consumers, who are dissatisfied with the automated message, can ring back and speak to an agent and so could be included in the survey anyway. Asking customers to complete a survey twice for the same initial concern is poor practice from a customer care perspective. In addition, it has the potential to bias the results of the survey.
- Although it has been established there are no issues regarding the data protection act from a DNO perspective, we still have a customer care concern regarding the passing of customers' personal details on to a third party without their prior knowledge and consent.
- Whilst in principle we support the idea of expanding the survey to include recipients of automated messages; in practice we are currently unable to identify some customers for this purpose. BT encrypts "number-withheld" call line identification information contained in the raw call data because they are concerned that not doing so would contravene data protection regulations.

In our response to the March Update paper we indicated our support to rationalising the survey questionnaire and would have welcomed the opportunity to work with all interested parties to consider questions which will better identify customers' expectations. We note now that the intent is to retain the existing assessed survey questions.

Finally, we are broadly supportive of the proposal to assess satisfaction with speed of response by means of a trial question in the consumer survey. We believe there is merit, at least in principle, in comparing customers' perceptions of speed of response with the quantitative reality described by the detailed statistics on actual speed which we provide every month.

It remains to be seen whether useful results will emerge from such an additional question, but, at this stage, a number of caveats must be borne in mind, especially if responses are used to inform targets.

- When assessing how satisfied customers are with the length of time taken to speak to an operator, they will be taking into account the length of time it takes to hear the message on the message answer service, listen to the Ofgem message and then the automatic call distributor queuing time. This is likely to distort customers' perceptions of the actual length of time taken to answer the call.
- Overall public perspective has shifted in recent times and customers now have higher expectations with regard to service. This includes, in some cases, that telephone calls should be answered straight away. In such cases these customers may not even be happy to wait for 15 seconds in an ACD queue.
- Targets set for the telephone speed of response will need to take into account the two different types of call handling systems as detailed in the RIG version 5.
- The customer survey targets, subject to reward and penalty, will need to be reassessed to reflect the inclusion of the level of satisfaction with speed of response in the survey.

Ofgem intends to develop a way of supplementing the annual incentive with an incentive relating to performance during exceptional events. This will be achieved by increasing the survey sample following exceptional events so that it becomes robust over a shorter period (e.g. one week). No revenue will be exposed in the first two years of the scheme as target levels of performance will need to be established based on performance during those years. Ofgem proposes that there should be equal rewards and penalties from April 2007 with 0.25% of revenue exposed.

In principle, we support the assessment of performance during exceptional events. However, we need to understand the feedback from Ofgem's proposed assessment period before fixing both the timescales and revenues exposed. The timescales are therefore premature and we would suggest that this is an area where an industry working group would be beneficial.

4.71-4.75 Undergrounding in Areas of Outstanding Natural Beauty

Ofgem recognises there is "some degree" of willingness to pay for this, and that it would provide "real benefits" to the public, but it provides no allowances because it is a matter of "public good", which is best decided by local or national government; the decision over forecast costs of £6.9bn is "too big" for an "economic regulator"; and such expenditure is of "questionable" consistency with Social and Environmental Guidance.

We believe:

1. Ofgem is the most relevant agency.
2. Ofgem is ignoring the best possible steer any agency could have on this, what customers want;
3. Ofgem is failing to take sufficient account of its own and DNOs' duties, under Section 62 of the 1995 Environment Act, to have regard to the statutory purposes of the Council for National Parks.
4. Ofgem is misrepresenting the "size" of the decision - the £6.9b comes from answers to an almost "academic" question – no DNO is seriously suggesting undergrounding ALL the overhead lines referred to;
5. By concentrating on the "base case" Ofgem is ignoring our plans for "environmental spending", which are small-scale, specific and will deliver clear benefits. The initial proposals contain no allowance for undergrounding for visual amenity reasons.

As Ofgem notes, the WTP survey indicates a willingness to pay for improvements in National Parks and AONBs. We consider that this is reflective of customers' environmental views, and, to the extent that it is ignored, that Ofgem can be said to be acting against customers' interests.

We are concerned by Ofgem's views and would ask that they consider again the issues raised by groups such as Friends of the Lake District. We consider that the improvements put forward are essential to meet our obligations under Section 38 of the Electricity Act 1989 and Schedule 9 statement commitments, specifically reinforced by s62 of the Environmental Act 1995. These obligations also are shared by Ofgem. Indeed the industry's obligation formed part of the Council for National Parks response to the first consultation paper on the Distribution Price Controls in July 2003.

Clearly large-scale spending for visual amenity is not practical, but we reiterate that the investment plans we submitted as part of our FB PQ **preferred scenarios** make allowance for a small number of pro-active environmental improvements which are effectively ruled out of the base case submission by the underlying assumptions.

In our preferred scenarios we included, for example, a small amount of selective undergrounding together with the use of appropriate substation designs e.g. pad mount

substations. These will result in more visually acceptable network designs in areas of outstanding natural beauty or sensitivity, such as the Peak District National Park in the East of our territory and the Forest of Dean in the West. Central Networks did not propose whole-scale undergrounding but rather modest targeted schemes that were part of our understanding of the approaches being taken by the statutory environmental bodies in our areas.

Consequently, we consider that there is an urgent need to evaluate our preferred scenarios, specifically in the context of environmental issues, and we welcome Ofgem's recently stated intention to engage with those parts of our submitted forecasts.

4.76-4.78 Environmental Reporting

Ofgem will introduce reporting of a small number of Key Environmental Performance Indicators under the RIGs. Further work is ongoing in conjunction with the DNOs and the final form of the indicators will be published in the September 2004 Update paper

We fully support Ofgem's recognition of the environmental responsibilities of DNOs. However, we still consider that the introduction of monitoring for environmental outputs of DNO activities without any supporting environmental objectives seems inappropriate.

We have commented on the proposed environmental measures in the response to draft RIG v5 and look forward to developing these further by ongoing industry consultation particularly through the Ofgem / DNO Quality of Supply WG

4.79-4.84 Discretionary Reward

Ofgem proposes to assess performance using a two-part annual survey; one part will request information from the DNOs on current practices and the other will be focused on key stakeholders such as social services, energywatch and other agencies.

Returns will be reviewed by a multi-disciplinary panel, which Ofgem intends appointing in the coming year.

The scheme will reward good practice, but there is no intention to penalise companies. Ofgem proposes that the total amount of reward available will be £1 million per annum in total (across all DNOs). The evaluation will cover the following three broad categories: priority customer care initiatives; initiatives relating to corporate social responsibility (e.g. activities with schools such as promoting safety awareness); and wider communication strategies implemented by DNOs (e.g. relationships with local health authorities or with other utilities in co-ordinating work).

Whilst any opportunity to earn additional rewards is welcomed, we reiterate that measurement criteria must be defined in advance if performance is to be measured objectively.

We welcome the use of a two-part annual survey to reduce reliance on one viewpoint and the outline of the areas proposed for evaluation i.e.:

- Priority customer care initiatives
- Corporate social responsibility initiatives
- Wider communication strategies

We look forward to working within industry forums and with the proposed stakeholder panel to develop the scheme further.

4.85 Other Issues

A number of companies have put forward forecasts for significant costs for improvements in quality of service specifically targeted at rural/worst-served consumers. In the light of the survey results, which show that there is little willingness of other consumers to help fund improvements in these areas, Ofgem has not included any additional allowance. Ofgem will consider this further if DNOs demonstrate that their proposals deliver net benefits to consumers.

The preferred scenarios contain a number of targeted performance initiatives, and we are pleased that Ofgem are now engaging in appropriate discussion. We have already had a meeting with Ofgem on 14 July 2004 and will follow up with additional supporting information to confirm our view that this represents best value for customers.

5. Distributed Generation, Innovation Funding and Registered Power Zones

Central Networks is pleased to see that progress on developing the incentive arrangements for distributed generation has been maintained and the overall framework is almost complete. This allows time for DNOs to prepare and put in place all necessary arrangements for a smooth start to the process in 2005.

5.8-5.13 – IFI

Ofgem confirms its March proposal for a profiled pass-through rate and provides the rates for each of the five years from 2005/06 to 2009/10.

Ofgem expects to review the joint-DNO good practice guide for managing R&D projects and will consider whether any specific guidance will need to be provided, and if so, what form it should take.

Allowable costs incurred between 1 October 2004 and 31 March 2005 for IFI projects initiated from 1 October this year will be treated as if they had been incurred in 2005/6 and will be subject to 90% pass-through.

A DNO will be required to inform Ofgem of its intention to take advantage of this facility by 1 September 2004. Ofgem will inform DNOs of the information it will require by 1 August 2004.

Central Networks believes the general proposals for IFI now look more robust, but we are concerned that fully identifying and justifying work up-front will stifle investment. Our preference is to allow some degree of retrospection or judgement when assessing whether or not expenditure is efficient or properly justified. This would enable us to be more flexible, to move faster with those projects that are going well and back off those that are not showing the promise initially identified.

We would also point out that, whilst we acknowledge the requirement that the net present benefit be greater than the net present cost, this is not a straightforward requirement. It is difficult to assign a financial benefit to supply quality, environmental and safety-led projects except in the broadest terms.

We are working with the ENA to develop a best practice guide and propose appropriate projects. Ofgem's input to the good practice guide will be welcomed.

5.14-5.18 RPZs

Ofgem proposes to increase the RPZ premium from the £3/kW level set out in the March document to £4.5/kW. The previously proposed cap of £0.5 million per annum remains in place.

Ofgem proposes to limit RPZ applications for registration to two per licensee per year. This limit will be reviewed in 2007. Ofgem does not intend to change the overall financial cap of £0.5m per licensee which will apply for the period of the next price control.

Central Networks welcomes Ofgem's proposal to increase the incentive rate and we will now seriously consider using the desk top solutions of innovation and turning them into power zones, to look for best practice solutions to generation connection and supply quality.

6. Cost Assessment

We have carried out a review of the financial numbers contained in Chapter 6, the supporting tables in Appendix 1 and the Price Control Calculations. This has highlighted a number of areas where:

- we have been unable to replicate the numbers included in the Initial Proposals document
- the numbers that are included in the Initial Proposals document differ from those we would expect to see

We sent a letter to Carl Hetherington on 12 July 2004 detailing our areas of concern and are awaiting a response.

6.9-6.62 Operating Costs

[Ofgem describes its five-stage approach to assessing operating costs.](#)

Ofgem has largely ignored DNOs' forecasts of costs for the DPCR4 period and has based its proposals mainly on regressions of normalised 2002/03 costs.

The proposed DPCR 4 operating cost allowances have been set at the higher of the upper quartile point of the base analysis and the average of similar points in the base, "total cost" and 9-corporate-group regressions. Whilst we welcome Ofgem's attempt to adjust for savings obtained through mergers by estimating an equation using data for the 9 company groups holding DNO licences, we are still concerned that the analysis does not arrive at neither an appropriate efficiency judgement nor a reasonable opex allowance. In particular, it:

- fails to find a way of justifying the extent to which differences between the estimated equation and an individual company's position should be deemed to be a sign of efficiency as opposed to merely the error present in any statistical process;
- retains bias from the misspecification of the basic equations and the definition of total costs, the omission of explanatory variables and the choice of a linear functional form;
- makes comparatively small adjustments when considering the impact of capital costs and mergers and does not consider their cumulative impact;
- assumes that the electricity distribution industry should be able to move rapidly to its estimated quartile point without justifying the speed of adjustment or considering the implications for average industry productivity growth rate.
- ignores the fact that allowances are insufficient given companies have rising cost bases from 2001 through 2003/4. This issue of the sustainability of any so called benchmark is an issue that requires urgent attention.
- makes insufficient reference to the companies' forecasts of future costs.

We consider these issues below.

6.12-6.27 Normalisation of Costs

[Ofgem describes the normalisation adjustments made to the 2002/03 cost data.](#)

Central Networks accepts that a process of normalisation is required to ensure consistency and comparability between DNOs for efficiency assessment purposes, but we believe Ofgem is attaching undue weight to the process when it comes to setting opex allowances going forward.

The normalisation approach so far has focused on removing atypically high costs, and no adjustment has been made for atypically low costs. This bias will generate estimates of costs which are unsustainably low. Central Networks has argued that operating costs including faults are understated in 2002/03. This is supported by our provisional 2003/04 outturn results which Ofgem will be reviewing shortly.

Over-reliance on 2002/03 data gives companies a significant risk and Ofgem needs to look carefully at 2003/04 data to ensure that “frontier” companies clearly exhibit sustainable cost levels going forward.

In addition, a number of cost items, which have been excluded as part of the normalisation process, are not one-off costs and represent on-going business costs. These include:

- Reorganisation costs / severance
- Storm costs
- Ex-gratia & guaranteed service compensation payments
- Bad debts

As a result the allowance given for storm insurance and atypicals is not sufficient to cover expected cost liabilities.

We have previously discussed these costs with Ofgem during the cost assessment visits and will detail them again in a separate letter.

6.28-6.51 Top-down Benchmarking

6.29-6.33 Composite Scale Variable (CSV)

[Ofgem describes its derivation and use of a CSV based on network length, customer numbers and units distributed.](#)

There has been no progress in developing more robust drivers of costs since the last price control review. The only change has been in the weights from 50% customer numbers to 50% network length, and Ofgem has done this without presenting any justification. The composite scale variable (CSV) used in the top-down benchmarking analysis is a very simplistic view of how distribution businesses operate and therefore any conclusions drawn from regressions which use them must be treated with a significant degree of caution.

Ofgem should instead have estimated a general equation using all cost drivers, instead of claiming prior knowledge of the impact of some cost drivers and confining the regression to the remaining drivers, network length, units distributed and customer numbers. In reality, the adjustment is uncertain and, had a general regression been conducted, the uncertainty would have been indicated by the standard error on that driver’s coefficient.

We continue to believe that the customer numbers element of the CSV underestimates the true cost of serving HV customers compared with a typical LV customer. We responded to you on this subject back in May but have received no feedback on this issue, nor was there any comment on this subject in the initial proposals. After conducting a study internally, we believe that a multiplier of 215 should be applied to HV customers in recognition of the size of the customer and the consequent cost impact on the network. The multiplier has been calculated on the basis of:

- the ratio between average HV unit per HV customer and LV unit per LV customer and;
- the ratio of HV to LV system costs.

Other drivers of cost have been ignored, such as topography and sparsity and the cost of reducing losses on the network. At the very least, such omissions need to be taken into account when interpreting the results.

6.34-6.42 Basic Regression

Ofgem illustrates its baseline regression and describes its use of the upper quartile as a benchmark.

We believe Ofgem has taken an unjustifiably aggressive stance on top-down benchmarking. One of the main reasons for this is that Ofgem has assumed greater certainty in the results of its basic regression analysis than is warranted by both the data and the technique itself.

There are many sources of uncertainty in the top-down benchmarking comparisons. The base data are themselves uncertain, varying from year to year, stemming from different accounting practices and are, in most cases, the result of allocations and internal transfers between entities within larger companies.

In most regressions uncertainty is revealed in the equation statistics, which are functions of the errors of the estimates, the difference between the equation estimate and the observed value. However, in Ofgem's approach, that difference is taken as a measure of the impact of another explanatory variable, relative efficiency, which is not directly observable and so is not included in the regression.

There is no certain way of deciding the extent to which it is reasonable to assign the equation errors to efficiency rather than to genuine error. Ofgem has chosen the upper quartile of the error distribution, between the third and fourth companies as an indicator of the extent of inefficiency, presuming that observations beyond that point (the first and second companies) may be the result of error.

The corrected regression technique represents the most extreme definition of the efficient frontier, and assumes that inefficiency is the only omitted variable and that there is no other error. Consequently it maximises the perceived inefficiency of a company, which in reality is not a true representation of comparative performance.

An alternative technique, stochastic frontier analysis (SFA), explicitly tests for the presence of inefficiency and measures its contribution to the residuals compared with the random error. However, with a sample set as small as that used by Ofgem, SFA is likely to conclude that there is zero inefficiency, which is at the other extreme to the corrected regression that assumes a great degree of inefficiency is present.

A further option for dealing with uncertainty is to use confidence bands around the predicted regression. The prediction interval around a regression line indicates the precision with which normalised costs can be predicted from the exogenous output levels, in this case the composite scale variable. Working with a desired confidence level, the prediction interval for the regression line can be calculated given the observations on the companies. The confidence limits for the predicted relationship are given by choosing a critical t value and calculating:

$$\hat{y} \pm t_{0.5I} [s.e.(\hat{y})]$$

If the COLS frontier is shifted down by a constant amount, e_f , then the confidence limits are also shifted to preserve the same prediction range. Figure 1 illustrates this shift.

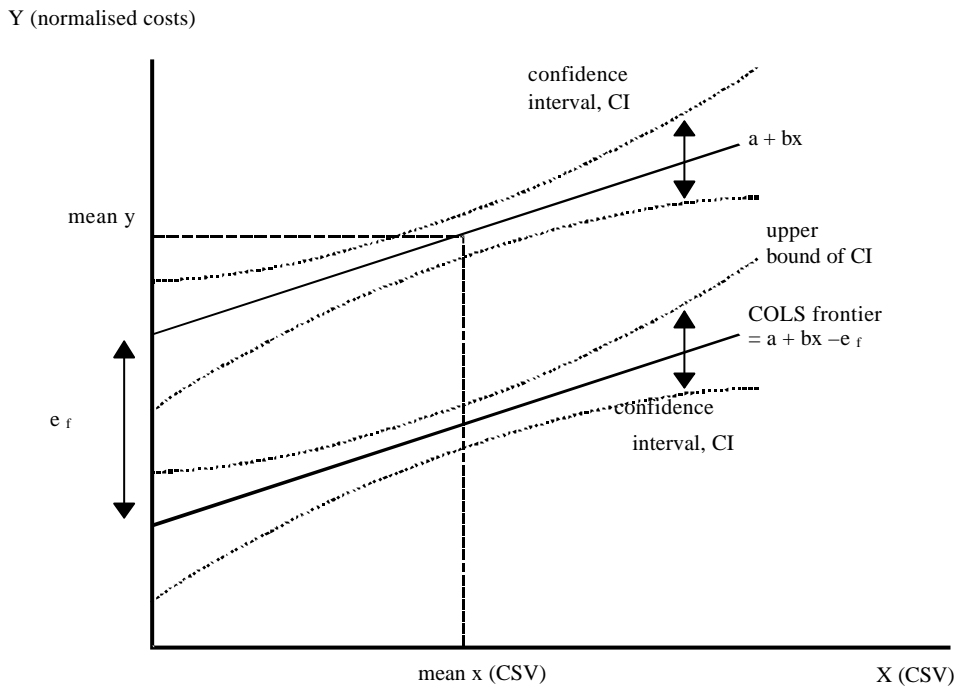


Figure 1 Applying confidence intervals to the average regression and COLS frontier

A detailed paper on confidence intervals, produced by Professor Tom Weyman-Jones, Head of Economics at Loughborough University, will be sent to you. In summary, we argue that the upper bound for the confidence interval, CI, around the shifted regression line should be taken as the effective frontier.

The implication of this approach is to say that there is a null hypothesis which starts from the premise that companies are not relatively inefficient, and hence Ofgem must prove that this is not the case. To assume otherwise builds an automatic bias into the analysis and conclusions that are subsequently drawn.

The closer that we require the upper bound of the confidence interval to lie relative to the COLS frontier, the lower is the level of probability that can be associated with the inefficiencies that are derived. Alternatively, the greater the degree of confidence that we wish to put in the choice of frontier, the wider is the confidence interval that will be calculated.

It is important to emphasise that these probability levels do not indicate the likelihood that inefficiency is present. They only state the confidence with which it can be said that, if all variation is due to inefficiency, then the individual company inefficiencies will not be lower than the figures stated. This is all the more important given the lack of panel data and hence the low number of observations available. Even if 2003/04 data is used, there are dangers in using the same normalisation assumptions applied to the 2002/03 data.

In using the upper quartile to set opex allowances, Ofgem has, in our view, presumed too low a level of confidence for what is required of a robust process. We must have a high degree of confidence in the statistical process to ensure that opex allowances are sustainable. For illustrative purposes, Table 1 shows the results of applying a 75% confidence limit to calculate efficiency scores.

Company	COLS efficiency	Upper quartile efficiency	Illustrative	Average efficiency
			75% Confidence Inefficiency	
EPN	80%	87%	93%	95%
EME	87%	98%	103%	109%
LPN	59%	70%	76%	81%
MAN	68%	81%	87%	94%
ME	74%	84%	89%	94%
NEDL	85%	102%	111%	119%
UU	71%	81%	85%	91%
SPN	62%	72%	77%	82%
Southern	100%	111%	118%	123%
WPD S. Wales	76%	93%	104%	112%
WPD S. West	69%	82%	88%	95%
YEDL	87%	100%	107%	114%
SCP	76%	87%	92%	98%
Hydro	80%	100%	111%	120%

Table 1. Comparing upper quartile efficiency with confidence intervals for a 14 company regression without any adjustments for mergers

The illustrated level of confidence is saying, in effect, that there is only a 75% confidence that the variation from the upper bound confidence frontier is due to inefficiency rather than random error, caused by factors such as the omission of cost drivers and capital costs and the errors inherent in any normalisation process. Conventionally, confidence limits of 90% or 95% are expected, but, even on the basis of 75%, AND without any adjustment for mergers, it can be seen that Central Networks East is efficient and Central Networks West is 89% efficient.

6.43-6.51 Alternative Regression Analyses

6.44-6.46 The Treatment of Mergers

[Ofgem has considered regressions using 9 ownership groups but does not propose any specific adjustment to account for non-merged and merged companies.](#)

Ofgem reiterates its view that “savings achieved by merged DNOs are attainable through other corporate structures and not exclusive to mergers between DNOs, therefore adjustments for merger savings are not necessary”. As Ofgem is aware, Central Networks believes that this view is demonstrably wrong and that Ofgem should reconsider its position.

There are a number of functional areas where synergies and savings can be achieved by merged DNOs which cannot be achieved by a single DNO that is a member of a wider group. The following are all activities specific to running an electricity network

- Regulation and business strategy
- Asset Standards, Policy & Investment Programme
- Delivery of work programmes on the electricity network
- Customer service, controlling and operating the electricity network
- Providing new connections to the electricity network

- Essential support services, including DNO IT systems

We have demonstrated through a number of letters, reports and presentations the extent of these savings and the flaws in Ofgem's current treatment of single DNOs.

We continue to believe Ofgem's present treatment of single DNOs is discriminatory and that it would be unsafe for Ofgem to rely on a comparison without proper adjustment of merged and single DNOs, and we have proposed a number of solutions to avoid this

6.48 Total Cost Analysis

[Ofgem describes its consideration of regressions using various measures of total cost and presents results based on average capex between 2000 and 2010.](#)

Ofgem's measure of expenditure does not accord with any normal economic definition of total costs. Total costs are operating costs plus capital costs, in the sense of the cost of the services of the capital stock. Capex, on the other hand, is expenditure on *additions* to the capital stock. Furthermore, it is, to say the least, eccentric that Ofgem's measure of average capex comprises seven years' worth of *forecasts*, which, of course, has no bearing whatsoever on current levels of efficiency. Indeed, Ofgem itself describes the approach as not having strong theoretical foundation.

The Frontier Economics report on "Balancing Incentives" (March 2003) argued that this methodology did not take account of past investment. In particular, unless all companies are at similar points in their investment cycle, the cash cost approach will ignore existing assets, and hence some companies with newer networks will appear more efficient compared with companies that have predominantly older networks. The report therefore recommended that since investment is long lived, a capital stock approach should be adopted for deriving total costs.

There is no reason to believe that capex (and particularly future investment) will be a reasonable proxy for the capital stock. If the stock of capital assets is relatively low, operating expenditure is likely to be relatively higher (because it is substituting for the services of new assets) and there is likely to be a greater need for capital expenditure to increase the capital stock. Thus, Ofgem's check might even increase the original misspecification.

In summary, we welcome Ofgem's recognition of the importance of total cost, but we believe a capital stock approach would provide a significantly better measure. DNOs' regulated accounts contain estimates of the regulatory asset base and depreciation. "Regulatory" capital costs can therefore be estimated as the sum of that depreciation and a cost of capital times the asset base. An alternative "CCA" measure could also be constructed starting from 1990 CCA values, adding subsequent investment (all indexed to current prices using the RPI) and subtracting estimates of economic depreciation based on asset lives.

Data Envelopment Analysis

In the second consultation paper on price controls (December 2003), Ofgem stated that regression analysis would be supported by data envelopment analysis (DEA). This policy was confirmed in the policy paper (March 2004). However, DEA is noticeable in Ofgem's initial proposals only by its absence.

DEA is a non-parametric technique and has the benefit of being potentially less sensitive to the low number of observations. It should be remembered however that DEA assumes

that stochastic errors are absent, and hence the scores shown will underestimate efficiency. One option to compensate for this is to shift the frontier up by a multiplier to reflect this uncertainty as illustrated in figure 2.

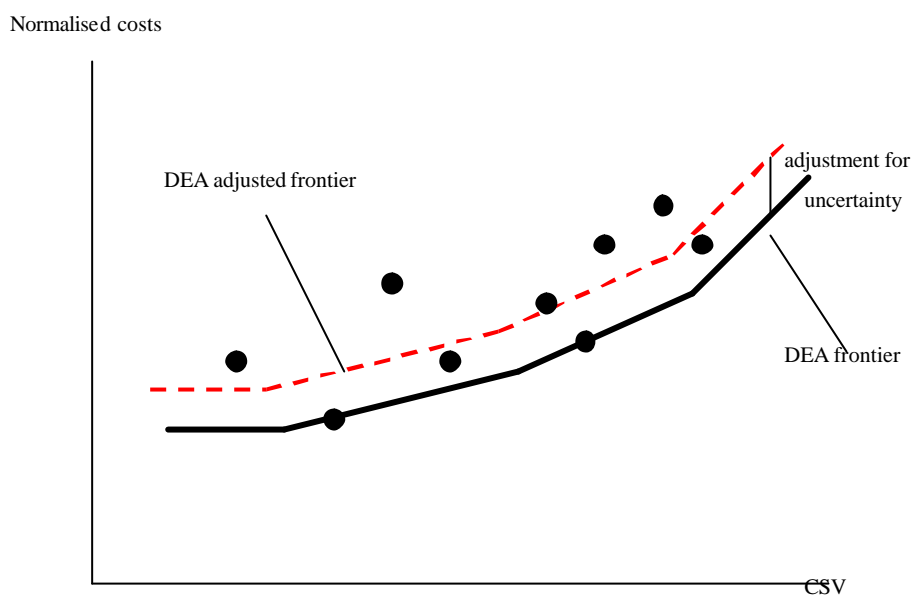


Figure 2. Adjusting the DEA scores for uncertainty

We have re-produced the top-down benchmarking analysis for 9 groups using DEA under the assumption of varying returns to scale as a sense check of the regression analysis set out in the initial proposals. Whereas in the regression analysis, the problem of multicollinearity requires the use of a composite scale variable, this is not the case for DEA and the three separate outputs (units, customers and line length), which have to be achieved separately, can each be incorporated in the analysis. This results in more companies being on the frontier. Table 2 below shows the efficiency scores as compared with Ofgem’s quartile efficiency.

Efficiency (%)	Opex plus total faults		
	DEA 3 outputs	DEA one output	Regression quartile
DNO			
Seeboard	91	91	70
UUE	91	91	82
Midlands	92	92	86
East Midlands	100	100	103
WPD	77	75	78
N&Y	100	92	98
SPMW	77	78	84
SSE	100	100	108
EdF	100	100	86

Table 2. DEA using a 9 group approach

Efficiency scores are higher under DEA compared with a COLS regression analysis, even prior to correcting for the fact that the DEA frontier assumes no stochastic error. For Central Networks, Midlands is 92% efficient and East Midlands lies on the frontier.

The paper that we are submitting, produced by Professor Tom Weyman-Jones, also introduces the concept of stochastic elements to DEA based on chance-constrained programming developed by Land, Lovell and Thore (1993)¹. This allows the model to be transformed into a non-linear programming problem. It will in effect replicate the adjustment to the DEA frontier shown in figure 2, by ascribing a proportion of the gap to “noise” (such as unspecified cost drivers, measurement errors etc) as opposed to “inefficiency”.

6.50-6.51 Conclusions on Alternative Regressions

Ofgem claims that none of the alternative regressions is superior to the basic regression model, but notes that the 9-group and total cost models do provide additional information on companies' efficiency and presents proposed opex allowances based on the higher of the average of the three alternative regressions and the base regression.

The preceding analysis demonstrates that there is considerable uncertainty in the comparisons and that results are affected by the method of comparison used.

Ofgem's analysis takes insufficient account of merger savings and we believe it is therefore discriminatory.

We believe Ofgem's use of an upper quartile approach presumes too great a confidence in the analysis as to the level of efficiency, rather than from factors such as the omission of cost drivers and capital costs and the errors inherent in any normalisation process.

Conventional statistical analysis would usually insist on a much higher confidence level of 90% or 95%, and anything less places a high degree of risk onto companies.

It should be noted that in DPCR3 companies were only required to achieve a cost allowance reflective of 75% of the “efficient” costs, in recognition of the errors within Ofgem's comparable cost analysis.

6.52-6.53 Other Evidence and Judgement

6.52 Ernst & Young Assessments

Ofgem describes E&Y's bottom-up operational efficiency analysis, claiming it is broadly consistent with the findings of the top-down benchmarking.

On the 8 July 2004 we received a copy of Ernst & Young's final draft report for Central Networks East & West. Contrary to Ofgem's claim, the potential operational efficiency savings suggested by Ernst and Young's bottom-up assessment are not consistent with Ofgem's top-down regression analysis.

Therefore we do not accept Ofgem's complete reliance on the top-down analysis as the basis for the view of efficient costs in 2002/03, and hence as the basis for setting DPCR 4 operating cost allowances. This view is supported by the additional top-down analysis that we have carried out above.

¹ Land, K.C., Lovell, C.A.K. and Thore, S. (1993), “Chance-constrained Data Envelopment Analysis”, *Managerial and Decision Economics* 14, 541 – 554.

It is also worth noting that at the last review, Ofgem did not put 100% weight on the uncertain econometric work. Instead the last review took the smaller of the two cost reductions produced by the consultants' work and the econometrics.

6.55-6.56 Achieving Benchmark and Glide-path

[Ofgem proposes full achievement of benchmark cost allowances without glide-paths.](#)

Glide-path

Ofgem has initially proposed no glide-path for achieving the “efficient” level of costs, which for Central Networks Midlands implies productivity gains of 7.6% per annum for 2003/04 and 2004/05. This is a more severe regime than that which operated at the last price control, where companies were given four years to reach the perceived level of efficiency (i.e. end of the second year of the price control). We do not support the current approach for DPCR 4, as it front loads all of the efficiency savings, expecting immediate catch-up by March 2005, which is neither realistic nor reasonable. It is also inconsistent with the calculations involved in determining the cost of capital that are based on an average over all companies. The averagely efficient company should earn the cost of capital; more efficient firms should earn more; and less efficient firms less.

We would also point to the approach adopted by Ofwat in the Water industry, whereby companies are expected to achieve a 60% catch-up to an adjusted frontier (90% of the corrected regression). This suggests that Ofgem’s approach is too harsh, and we would therefore urge the adoption of a glide-path, giving a reasonable timeframe to achieve the “efficient cost allowance”.

Frontier shift

Ofgem has assumed a frontier shift of 2 per cent per annum from April 2005. This implies that Ofgem expects DNOs to outperform the general productivity of the UK economy, which is 1.3%, by 2 per cent each year. This is extremely challenging for DNOs for a number of reasons.

- It is significantly more challenging than DPCR3:
 - DPCR 3 assumed no frontier shift, and allowed the efficiency incentives to drive future performance.
 - DPCR 3 provided some protection to companies against the risk of setting unrealistic cost targets which have a direct impact upon cash-flows and credit rating.
 - Ignores the impact that the much weakened opex incentives have on being able to deliver on going efficiency improvements in DPCR 4.
- Past performance is not a guide to future performance, especially since the last decade was significantly affected by the removal of inherited inefficiencies at privatisation.
- CEPA report is not a guide to future trends, because it is largely historical, and includes data which is not related to the distribution business such as the supply business.
- We are concerned that TFP has not been split between catch-up and frontier shift and hence there is considerable risk of double counting.
- Assumes the chosen frontier is perfect, and hence ignores the considerable uncertainty regarding benchmarking

- Ignores the fact that there are upward cost pressures facing the industry including the "perceived" frontier DNOs, and hence this assumption seems inconsistent with the future environment in which companies will be operating.

Overall Conclusions

Ofgem has adopted a far harsher opex regime than was applied at the last review, but we believe the benchmarking process, on which it is based, is significantly flawed, particularly in its treatment of mergers, and is unreliable for deriving opex allowances.

Ofgem's current approach, coupled with the proposed reduction in incentives and rewards for potential out-performance of the allowance, is unacceptable to Central Networks.

We have demonstrated to Ofgem, both within this response and in separate communications, a number of approaches which are widely accepted for comparing efficiency, and believe these to be more robust than the analysis and results presented in the initial proposals.

We believe the uncertainties of the analysis point to a need for greater emphasis on our submitted forecast business plans.

6.63-6.107 Capital Expenditure

Historical Capex and RAV Roll-forward

Ofgem notes that work on this is ongoing, but makes initial estimates.

It is difficult to comment on the specific RAV roll forward adjustments made because, as detailed in our letter to Carl Hetherington on 12 July, we are unable to reconcile:

- the adjustments detailed in Table 6.6 to the RAV roll-forward spreadsheets sent to Ofgem;
- the additions shown each year in Table A8 to those included in our FB PQ submissions.

We would appreciate it if you could provide us with a full audit trail to support the numbers included in these tables.

We welcome the opportunity to further debate the applicability of these adjustments at the bilateral meetings, which have been arranged for July / August.

6.69 Review of Future Capex

We welcome the fact that, subsequent to the initial offer, Ofgem has turned its attention to our preferred cases. We will work proactively to convince Ofgem of the benefits, which we believe will justify implementation of our plans in their entirety.

Our response here comprises our high-level comments on PB Power's assessment. This will be supplemented by a more detailed response to the PB Power report and further information requested by Ofgem on the "preferred" case.

Ofgem considers the base case capex scenario in isolation from the quality of supply scenario and excludes, pending further consideration, any expenditure aimed at complying with the ESQC Regulations. Because both Central Networks East and Central Network West attempted to exploit synergies between base case aims and ESQC regulations or quality of supply, Ofgem's treatment of the investment plans makes it difficult for us to comment on the adequacy of the proposed capex allowances.

In addition, we believe a number of the PB Power adjustments identified within the document are unjustified, and we find this particularly disappointing as these issues have been discussed with PB Power during their visits and subsequently.

More detailed comments on the capex proposals follow, but here we wish to highlight two particular areas of concern.

Within the Central Networks East plan for DPCR4, a significant proportion of the expenditure required to maintain the performance of the overhead network was also required for compliance with the ESQC Regulations. Within the submission, this work was identified as ESQCR expenditure but, perhaps more appropriately, as the investment maintains reliability and performance, it could have been categorised as non-fault replacement. Ofgem has recognised the specific issue in the East and we have therefore resubmitted the forecast with a revised classification of some of this expenditure as maintaining quality at base levels.

Similarly, for Central Networks West, a major part of the planned HV reinforcement work was specified to produce quality of supply benefits, and so, working to the defined assumptions for the base case, this work was included within the quality of supply improvement scenario. The proposal is that the allowance for quality of supply improvement will be reduced from the company's original submission, but there is no

clarity on what work Ofgem considers unnecessary, so the adequacy of the non-load related allowance remains in doubt.

Some of PB Power's non-load related capex adjustments undervalue network investment requirements. This particularly applies to LV Consac cable and LV overhead lines, where fault rates and replacement practice require higher levels of allowance.

Central Networks West has proposed a number of network load related reinforcement schemes aimed at maintaining the operational integrity of the network and compliance with licence conditions. These have been included in the base case because they address network security issues and do not fundamentally change fault rates or performance. The network has been managed at unsustainable levels of increased risk during DPCR3, resulting from reduced load related allowances, and therefore continued operation at such a level is not desirable.

PB Power proposes a cut in base case capex allowance, equivalent to the schemes that will reduce security risk, on the basis of their interpretation of base case assumptions, where they state that a reduction in risk can be interpreted as an improvement in performance. They do not dismiss the validity of the schemes and suggest that they should be considered as part of the DNO Alternative Scenario.

We welcome the suggestion for a sliding scale approach to capex allowances that would allow companies some discretion with regard to the actual capex spend on their networks. However, this should not be a substitute for Ofgem agreeing an allowance that fully meets the requirements for network investment whilst providing an adequate return on that investment for the companies during the DPCR4 period.

We continue to support ongoing dialogue with Ofgem to resolve these issues and present here our main views on Ofgem's proposals.

6.69 – 6.78 Summary of the Process to Arrive at the Capex Allowances [Ofgem sets out a background and summary of the capex modelling process.](#)

The submissions presented to Ofgem were constructed from the viewpoint of network need, and specified to maintain existing performance, manage risk within acceptable levels and be deliverable. The submissions were prepared to take into account synergies between different types of work being carried out on the assets, e.g. for condition or safety reasons, and, where synergies were identified, consequent reductions in the level of funding requested were realised. PB Power's proposed reductions to our funding requests will have detrimental effects on the synergies used in our submission, and we will require allowances for extra work to be carried out to meet base case aims. If an additional allowance is not forthcoming, then it must be recognised that the work cannot simply be deferred until DPCR5 without increasing risk.

Although models have been developed for both load and non-load related expenditure, only headline conclusions have been provided by way of explanation. For this reason it is difficult to provide informed comment on the accuracy or applicability of the output from the models and we press for the actual models to be made available to the companies to enable an informed debate to take place.

We are pleased to note that PB Power has since given us a view of their reports to Ofgem and we will be commenting on them separately.

6.86 Forecast Review Adjustments

Table 6.8 sets out an overview of the differences between the “adjusted” DNO forecasts and PB Power’s view

PB Power has proposed adjustments of £45m to the Central Networks West submission and £38m to that of Central Networks East, based upon the output of the modelling. PB Power’s reports describe the processes and inputs but detailed output results have not been shared. This is particularly disappointing in light of the detailed information that has been provided to PB Power both during, and subsequent to, the capex meetings between the companies, Ofgem and PB Power. Our comments on the proposed adjustments are as follows.

Central Networks West - Load Related

Ofgem proposes to reduce the capex allowance by £17m, mainly on the grounds of unnecessarily reducing network risk.

Central Networks West has proposed a number of load related reinforcement schemes aimed at maintaining the operational integrity of the network and continued licence compliance. Operation at current levels of risk, resulting from reduced load related allowances in DPCR3, is not sustainable.

PB Power proposes a cut in base case capex allowance, equivalent to the schemes that will reduce overall risk levels, on the basis of their interpretation of base case assumptions, where they state that a reduction in risk can be interpreted as an improvement in performance.

The unsupported assumption is that the current level of network risk is acceptable. In fact, the current level of risk has been brought about by a load-related allowance well below the Company’s submission in DR3, and it is not a level at which Central Networks is comfortable. Clearly we have worked within the allowance to manage the short-term risks and, as you are aware, we have ploughed back efficiency savings to deliver extra functionality. However in the longer-term we do not believe this level of risk is sustainable, and hence the schemes are necessary and £10m must be reinstated in the base case.

It should be noted that PB Power does not dismiss the validity of the schemes, suggesting that they should be considered as part of the DNO Alternative Case. Central Networks West included these schemes within base case, in line with the assumption that they do not improve performance or fault rates.

Central Networks East - Load Related

Ofgem proposes to reduce the capex allowance by £30m, mainly on the grounds of insufficient support for reinforcement of switchgear and the risk of re-phasing schemes until after 2010.

This proposed reduction is unacceptable to Central Networks. It would reduce total load related expenditure to an unsustainable level and increase the risk of network failure.

The change programme for overstressed switchgear is based on the revised fault levels supplied by National Grid. Central Networks considers the National Grid Policy and Practice of changing switchgear, which is in excess of 95% of its fault rating, to be consistent with an acceptable level of risk, and the proposed programme is based on this threshold. In fact, the majority of the switches proposed for change during the DPCR4 period are currently beyond 100% of their safe operating level.

Central Networks is aware that several issues affect the fault level calculations within the IPSA network model, but these are likely to increase the calculated fault level by up to 5%, and therefore there should be no reduction in our proposed investment for over-stressed switchgear.

Reduction of the earth loop impedance expenditure identified in the PB Power June Report will result in Central Networks carrying a higher level of health and safety risk than we believe is acceptable. Mitigating action therefore needs to be taken and there should be no reduction in our proposed investment.

We have similar concerns with regard to proposed investment allowances for major substations and other load-related reinforcement expenditure, which will be addressed in our detailed response to the PB Power report.

Central Networks West – Non-load Related

[Ofgem proposes to reduce the capex allowance by £28m to maintain performance at base-case level and set LV Consac expenditure to industry levels.](#)

PB Power claims that the Ofgem 2002/03 Electricity Distribution Quality of Service Report provides no evidence that the replacement of LV overhead lines is a requirement. However, the information in the Quality of Service report is very limited in nature and therefore is not the means by which such issues are identified.

Central Networks West submitted information to Ofgem in the 2003/04 Medium Term performance report, showing an increasing trend in faults on LV overhead line due to “company causes and faulty manufacture”. This illustrated an underlying upward trend in fault rates, implying a potentially deteriorating asset. It is therefore inaccurate for PB Power to suggest that forecasts are not supported by increased fault rates.

The historical level of replacement of overhead lines by Central Networks West has been lower than that carried out by other industry operators and therefore an amount of “catch up” is required. Forecast volumes have been calculated assuming a 75 year mean life, resulting in 150km to be replaced during DPCR4. This volume represents a replacement cycle of 200 years, which by no means can be considered excessive.

The increased expenditure over DPCR3 levels is required to counteract the observed rise in faults related to the condition of the asset and we therefore believe that the proposed £14m should be reinstated to the base case.

PB Power has also proposed a reduction in the allowance to fund Consac cable replacement to bring our intended expenditure to ‘industry levels’. This is wholly inappropriate, for, as PB Power has observed, asset management practices for dealing with Consac differ throughout the industry.

PB Power’s report indicates that some DNOs address cable joint problems. This contrasts with the approach of Central Networks, which has an active programme of Consac cable replacement that is deployed reactively in locations where successive fault repairs and the replacement of faulty short sections do not deliver acceptable service. In certain situations the same length of Consac cable fails repetitively, causing nuisance faults and safety issues for customers (due to lost neutrals). Where these situations arise the cable is deemed to have passed its useful life and is replaced in its entirety.

This difference in practice means that comparative volumes will be higher for Central Networks due to the approach of replacing whole lengths rather than just the short sections associated with joint positions. Furthermore, when replacing entire lengths, all

services need to be transferred onto the new cables, and so the unit cost is higher than just the cost of laying a new cable.

Restricting the allowance for replacement of Consac cable to industry levels will lead to an increase in faults on our Consac networks, with the consequent impact on customer interruptions and safety.

The planned expenditure of £33m for DPCR4 is not excessive and equates to a replacement life of 102 years. Again we believe that the proposed £10m should be reinstated to the base case.

Central Networks East – Non-load Related

[Ofgem proposes to reduce the capex allowance by £8m for cable replacement and easement costs.](#)

We are unable to identify any justification for the £8m reduction, other than PB Power's "Opinion of Allowances".

The total submission for cable reliability at all voltages amounts to £6.5m over the entire 5-year period. This figure is below current (2004) expenditure levels and was based on spend levels during the first three years of DPCR3. These figures were reduced by expenditure to proactively repair fluid filled cables in the previous period. The submission will present a real delivery challenge to maintain performance of the cable network, and, unless further information is forthcoming on the apparently arbitrary proposals of PB Power, we see no reason why we should accept such a reduction in our allowance.

The base case rules required that expenditure on wayleaves-related work should remain at existing levels. This was identified in our submission as not reflecting the true picture within the Central Networks East region, where concerted activities by external influencers have resulted in year on year increases. The preferred scenario we submitted to Ofgem reflects this. It is clear that this work is obligatory, does not contribute to network performance and requires an appropriate allowance.

6.87 ESQCR

[Ofgem has excluded the costs associated with ESQCR compliance from the current proposals and proposes to continue to review the issue with a view to allowing recovery of efficient costs.](#)

Central Networks welcomes the proposal to investigate the requirements placed on the electricity supply industry by the Electricity Supply Quality and Continuity Regulations (ESQCR) with the Department of Trade and Industry (DTI).

However, the proposed withdrawal of £66m from the capex allowance for Central Networks East and replacement by an 'Industry Norm' is not acceptable to Central Networks.

The removal of the planned 11kV overhead line work from our proposals will invalidate the capital submission as Central Networks East will not be able to 'maintain current levels of performance' as requested by Ofgem in the preparation of the base case.

Ofgem has recognised the specific issue in the East and we have therefore resubmitted the forecast with a revised classification of some of this expenditure as maintaining quality at base levels. This leaves an ESQCR forecast for Central Networks East of £7.3m.

6.88 – 6.106 Setting capex allowances and investment incentives

[Ofgem proposes using a sliding scale mechanism to set capex allowances.](#)

We broadly welcome the suggestion for a sliding scale approach to capex allowances that would allow companies some discretion with regard to the actual capex spend on their networks. However, this should not be a substitute for Ofgem agreeing an allowance that properly addresses network need for investment, whilst providing an adequate return on that investment. There is a danger, which we need to avoid, that the sliding scale may inadvertently create a climate where less rigorous delineation of network need becomes prevalent, which we are sure is not Ofgem's intent.

Practical implementation of this mechanism will require further clarification and development and we look forward to working with Ofgem to achieve this.

7. Financial Issues

7.3–7.8 The Cost of capital

Ofgem is proposing a pre-tax cost of capital of 6.6%, the middle of Ofgem's previously proposed range of between 6% and 7.2%.

We continue to believe that, if Ofgem wants to create the necessary climate for investment and attract equity to fund replacement of DNOs' ageing networks and facilitate distributed generation, Ofgem will need to raise its proposed cost of capital to at least the top end of its earlier proposed range and possibly beyond.

We believe Ofgem's proposed cost of capital takes insufficient account of three broadly defined factors:

- DNOs' future risk-reward profiles
- The dividend growth model (DGM) and
- Precedent and Market expectations

DNOs Future Risk-reward profiles

Ofgem's proposals increase the risks on DNOs. In particular, Ofgem has cut capex bids by 25%, put in place a rapid convergence on the efficiency frontier, toughened the faults regime, increased revenue exposure under the quality of service incentives, rejected full pass-through of the costs of connecting distributed generation and made all connections subject to "shallow-ish" connection charges. These factors mean that risk has gone up relative to the last period, not down. These should be reflected in the cost of capital.

Moreover, investors have expected to receive returns from the regulatory contract, based not only on the allowed cost of capital, but also on out-performance of the opex and capex efficiency incentive schemes. As a result of the changes in approach to setting opex allowances (referred to earlier in our response), the reduced scope for future gains, and Ofgem's proposed changes to the incentive schemes, opportunities for DNOs to gain rewards for out-performance during DPCR4 are unlikely to be significantly positive, and may even be negative. We believe that investors will need a higher cost of capital to compensate for the reduced reward opportunities.

Importantly, we believe that at the time Ofgem announced its initial range, a number of the proposals which expose DNOs to more risk or limit the out-performance opportunities were either not known or at an embryonic stage and so could not have been factored into Ofgem's thinking on cost of capital. For example, increasing the revenue at risk from extending the quality of service incentives would never have been picked up in the measured betas that under-pin the cost of capital numbers in the March policy paper.

In addition to the effects of Ofgem's proposals on DNOs' risk-reward profiles, there are a number of "external" factors which we believe have not been taken into account in the proposed cost of capital.

Unlike at DPCR3 the prospect is for rising interest rates in the next period. This time the risks are in the other direction and no allowance has been made for this in the cost of capital calculation.

Two further areas that require consideration are an allowance for embedded debt and for debt issuance fees. Work done in these areas, particularly in the water industry, suggests that around 0.25% should be added to the cost of debt and around 0.3% to the cost of equity. These would extend the top-end of Ofgem's range in the March policy paper.

The DGM

Ofgem has committed itself to using the DGM as a check on the results of the CAPM. The DGM suggests that a cost of equity figure toward the higher end of the range may be appropriate. The range for the cost of equity derived from this methodology is between 6.96% and 7.75%, assuming current and recent distribution company dividend yields, and ongoing growth in the distribution dividends. This compares with the 5.75–7.25% established from the CAPM.

Precedent and Market Expectations

There is a wealth of regulatory precedent demonstrating that choosing a value towards the high end of the range identified through CAPM is appropriate when a significant investment programme needs to be undertaken. Just within the last year, the CAA chose a value higher than the mid-point of the cost of equity estimated through the CAPM when reaching the point estimate of BAA's cost of capital. This builds on practice over a longer period of time—for instance, by the Rail Regulator in his 2000 review of Railtrack's track access charges.

From the city reaction it is clear that analysts expect an increase from the mid-point of the range to provide equity investors with sufficiently attractive returns over the long term. We also note that there is clear expectation that the allowed figure will not be less than that allowed in the water sector.

"In its March policy document, OFGEM indicated a range of allowed return of between 4.2% and 5.0% post tax real (equivalent to 6.0% to 7.2% pre-tax). We expect OFGEM to alight on a single figure in the draft proposals. The companies have all argued for a WACC above 5%. In our view, an outcome that is not towards the top of the OFGEM range will be disappointing." Andrew Wright - UBS

"The assumed post-tax WACC of 4.6% real is still well below the level companies would like, and below OFWAT's promise of at least 5%. OFGEM were keen in yesterday's conference to say that no decision had yet been made and the figure was merely the middle of the previously presented range. We still expect OFGEM to end up close to 5% by the time of the final proposals." Martin Brough – DrKW

"As expected, Ofgem has used a 4.6% post tax real WACC, the mid-point of its low 4.2-5.0% range. Ofgem intends to keep its options open and therefore we do not expect a definitive view on WACC until the late November 2004 Final Proposals. In our view, 4.6% is too low to be attractive to equity investors, unless future incentive structures combine to deliver at least 150bps of out performance potential. Evidence today suggests that the proposed incentives will not deliver this."

Philip Green - Merrill Lynch

It is widely acknowledged that DPCR4 presents a significant investment challenge to DNOs, both to facilitate distributed generation and in terms of asset renewal and replacement. DNOs will be competing for finance with the water sector, which will also be raising funds in the same capital markets with similar regulatory risks, but with more attractive returns:

"We think the evidence is strong enough to suggest that Ofwat will (and should) adopt a 5.25% post-tax real WACC for AMP4, but we cannot rule out 5.0% as the final outcome. A 5.0% cost of capital would not, in our view, provide equity investors with sufficiently attractive returns over the long term." Peter Bisztyga - CITIGROUP SMITH BARNEY

It is essential, if we are to fund the investment encouraged in the initial proposals, that a comparable cost of capital is used across the utility sector.

Ofgem's proposed cost of capital will not encourage equity and rights issues into the future. On the contrary, even taking account of the tax treatment, the incentive to gear up will be reinforced, in contradiction to Ofgem's stated intentions.

7.9-7.14 Tax and Gearing

[Ofgem describes its broad assumptions for the purposes of calculating tax allowances.](#)

Our calculations for tax allowance give significantly higher figures than the figures shown in the price control calculations. We have not yet seen Ofgem's financial model so we have been unable to review the tax allowance calculation, however we believe a number of the assumptions made by Ofgem are flawed:

- Paragraph 7.11 states that "Capitalised faults and non-operational capex are assumed to be opex." In practice this is not how capitalised faults and non-operational capex are treated for tax purposes. This assumption has the effect of understating the tax charge or allowance.
- Ofgem has different views of opening tax pool and how capital additions are allocated to the tax pools
- Paragraph 7.11 of the consultation states that "amounts of expenditure that are assumed to be eligible for capital allowances are split between the various different capital allowance pools in accordance with each DNOs own tax computation for 2002/03". Ofgem has not done this; a different percentage split has been applied every year.
- Ofgem has not included any adjustments for disallowable opex and capital expenditure in revenue. These are necessary adjustments required to calculate a tax charge, and, if excluded, result in an understatement of the tax charge or allowance.

This is a significant issue and we are pleased that GEMA now see this as a priority area for understanding and resolution.

7.15-7.31 Pensions

[Ofgem notes it has applied the approach to pensions set out in the March 2004 document, but recognises there are a number of issues still under consideration.](#)

We welcome the recognition by Ofgem that it was efficient for companies not to make contributions to the scheme that were not needed at the time

However, we continue to have significant concerns regarding the treatment of Early Retirement Deficiency Costs (ERDCs). The basic principle of regulation is that efficiently incurred costs and actions should be allowed and recoverable. We believe the costs associated with ERDCs are a legitimate business cost that has delivered substantial savings to end customers. Whether they were paid at the time of the efficiency or deferred via the legitimate use of pension surpluses, they represent a cost that should, at least in part, be passed through to customers. Where the surplus has been used, the deficit that now exists within the scheme should not be reduced by the extent of the ERDC in determining the allowable pensions cost.

The DPCR3 settlement was agreed (by Ofgem and DNOs) in the full knowledge that restructuring costs and severance costs were not fully provided for, but the pension surpluses were there and would be used. The use of pension surpluses to finance ERDCs is the most customer-beneficial use of such surpluses.

Pension deficits were not foreseeable (and not assumed) in the DPCR3 settlement and therefore the entire pension deficit (including all of the ERDC use of surplus) should be an allowable expense.

Customers should now pay for the benefits they have received in the past through the efficient use of ERDCs. Ofgem have the figures to assess when each DNO had the benefit of reduced staff numbers through use of surplus to fund ERDCs, therefore no standard approximation of benefit to DNOs and to customers is required.

There are a number of other technical issues that still need to be addressed:

- As noted in the Initial Proposals document no adjustment has been made to the estimates of ERDCs provided by the companies to reflect the investment returns that would have been earned had ERDCs been funded at the relevant retirement dates. We welcome Ofgem's acknowledgement that such adjustments should be made.
- Ofgem has spread the remaining allowed pension deficit over 13 years to provide the annual amount of funding for those deficits. We proposed that the deficits should be spread on a discounted basis; dividing by 11 gives a more accurate figure.

7.32–7.45 Financial Indicators

We welcome Ofgem's commitment to propose price controls that are consistent with companies maintaining credit ratings that are comfortably within investment grade.

Without sight of Ofgem's financial model it is difficult to comment on Ofgem's assessment of Central Network's financial strength. We welcome the opportunity to review Ofgem's financial model in the near future and provide further comments on financial indicators at that point.