David Gray
Managing Director Networks
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Central Networks
Pegasus Business Park
Castle Donington
Derbyshire
United Kingdom
DE74 2TU
central-networks.co.uk

Bob Taylor
T 01332 393300
F 02476 425794
Bob.taylor
@central-networks.co.uk

9th August 2004

Distribution Price Control – Supplementary Response to Initial Proposals

Dear David

This letter is a supplement to the main response we made on 27th July to the Initial Proposals.

We are pleased that Ofgem has shown us in the meantime its derivation of the proposed quality of supply targets and allowances and delivered a copy of the financial model.

We are particularly pleased to see that Ofgem is now engaging with our "preferred case" for capital expenditure. We have consistently argued that it represents best value for customers, and we look forward to convincing you of this in the forthcoming meetings between us.

This letter comprises our responses to the following appendices and some further thoughts on metering.

Appendix 145b	**Further details on the incentive schemes for distributed generation, innovation funding and registered power zones**
Appendix 145d	**Developing Regulatory Impact Assessments**
Appendix 145g	**Regulatory Instructions and Guidance Version 1 - Distributed generation, innovation funding incentive and registered power**

Central Networks East plc
No 2366923

Central Networks West plc
No 3600574

Central Networks Services Limited
No 3600545

Registered in England and Wales

Registered Office:
Westwood Way
Westwood Business Park
Coventry, CV4 8LG

In addition, Central Networks has contributed to an all-DNO response to *Appendix 145a - Structure and scope of price control modifications*, which will be delivered to Ofgem from the ENA.

Metering Price Control

Work has been continuing through the metering working group on the MAP and MOP price control. As a result of further information provided, it has been determined that the return calculated by Ofgem as part of the MAP price caps is lower than the stated 6.6%. This is due to the methodology being adopted by Ofgem. Central Networks has written separately to the metering price control team providing detailed analysis of the calculation. The price caps will need to be revised to take account of the correct calculation of the return on capital.

We look forward to ongoing useful dialogue.

Yours sincerely

Bob Taylor
Managing Director

PART 2 OF CENTRAL NETWORKS' RESPONSE

TO

OFGEM'S INITIAL PROPOSALS DOCUMENT

JUNE 2004

Central Networks' response to the main document was made separately and delivered to Ofgem on 27th July. In addition, Central Networks has contributed to an all-DNO response to <u>Appendix 145a - Structure and scope of price control modifications</u>, which will be delivered to Ofgem from the ENA.

This document comprises responses to the following appendices:

- **Appendix 145b - Further details on the incentive schemes for distributed generation, innovation funding and registered power zones**
- **Appendix 145d - Developing Regulatory Impact Assessments**
- **Appendix 145g - Regulatory Instructions and Guidance version 1 for distributed generation, innovation funding incentive and registered power zones**

CENTRAL NETWORKS' RESPONSE TO

APPENDIX 145B
FURTHER DETAILS ON THE INCENTIVE SCHEMES FOR DISTRIBUTED GENERATION, INNOVATION FUNDING AND REGISTERED POWER ZONES

Distributed Generation Incentive

1.14 Micro-generation

Ofgem will include micro-generation within the distributed generation incentive scheme.

Central Networks welcomes this decision. The inclusion of micro-generation will mean that DNOs will have an incentive to connect all generation without discrimination.

1.15 High Cost Projects

Ofgem proposes to supplement the previously announced threshold of £200/kW with an additional threshold of a total cost of £100,000.

For reasons explained in previous responses, we still believe that the £200/kW ceiling is too high.

We understand that inclusion of micro-generation within the incentive scheme prompts the need for an additional threshold. Assuming that "total cost" here means the total cost of all the assets installed to make a connection (i.e. including both a customer's and a DNO's contributions), Central Networks is supportive of this proposal.

1.21 Connection Boundary

Because the calculations for the incentive rates were based on forecasts of "shallow" connection charges, Ofgem proposes two options for ensuring that distributed generators do not pay twice for upper-network assets. Option 1 is a resetting of the proposed incentive rates based on adjusting the forecasts to reflect the "shallowish" boundary. Option 2 involves retaining the incentive rates, but making necessary adjustments once connections are made.

Central Networks acknowledges this problem and favours option 2 as the solution.

Option 1 will add a burden of unnecessary work with limited value. It also runs the risk of provoking unnecessary disputes and undoing the progress made so far.

Option 2 has the virtues of being simple and based on "real", not forecast data, which is going to be collected anyway.

1.25 Ongoing Incentive for Network Access

Ofgem maintains its proposal for a £0.002/kWh rebate rate and proposes a formula for the calculation of rebates to generators for network unavailability.

We continue to believe that, in principle, this proposal is unfair on demand customers who are the majority of network users. We recognise Ofgem's aim to encourage development of distributed generation; however, we do not believe that this is the most suitable form of incentive. It will place overly complex and time-consuming burdens on DNOs in terms of tracking durations of unavailability per generator and in terms of management, payment and reporting systems. Moreover, as generators themselves have said, most payments are likely to be derisory. Indeed we envisage it likely that the costs of making most payments will exceed the payments themselves.

Under the proposals, a medium sized generator (for example, 1 MW) with an annual total of 24 hours of network unavailability would be provided with a rebate of £2 x 24 x 1 = £24; we believe the cost of administering such a scheme for this generator would far outweigh this rebate amount.

Central Networks outlined a potential alternative at the Distributed Generation Working Group, which we believe would be simpler and more effective, and should be given further consideration. In effect we propose the introduction of penalty payments akin to the guarantee of service payments for demand customers, but using network interruption timeframes as the basis for payment.

The following table illustrates the form of the penalties we envisage.

Generator Size (MW)	**Penalties For Network Unavailability**	
	Up to 18 hours	**Every 12 hours thereafter**
0 – 0.9	£?	£?
1 – 9.99	£?	£?
10 – 100	£?	£?
100 and above	£?	£?

This method would enable the DNO to use existing reporting and IS structures to manage the process and minimise the considerable time and system start up activities which would be required in the original proposal. We urge Ofgem to seriously consider this proposal.

1.30 Treatment of Tax

Distributed generation incentives have been based on a pre -tax cost of capital; Ofgem proposes to adjust them to be aligned with the final position for the main price control.

Central Networks agrees that the treatment of tax for distributed generation should be aligned with that for the overall price control.

However, as we have already indicated in our response to the main document and in subsequent meetings with Ofgem and GEMA, tax is currently a significant issue in Ofgem's financial modelling so we would urge caution before proceeding in this area.

CENTRAL NETWORKS' RESPONSE TO

APPENDIX 145D
DEVELOPING REGULATORY IMPACT ASSESSMENTS

PART 1 OVERALL PRICE CONTROL

Costs and benefits

2.11 Ofgem asks for views on its initial proposals package and in particular a quantification of, and the balance between, the costs and benefits that would arise from the price control.

General View of Proposals
As we said in the letter which accompanied our response to the main document, we have serious concerns with the overall package of initial proposals, believing that:

- The proposed cost of capital is too low.
- Although Ofgem has acknowledged broadly that our investment plans are justified, the proposed allowances for capex remain too low and do not represent best value for customers.
- The proposed allowances for opex are unreasonably and unsustainably low, being based on a seriously flawed methodology, taking insufficient account of costs such as tax and pensions, expecting unjustifiably high improvements in productivity and, in Central Networks' case, taking insufficient account of mergers.
- The incentives and opportunities for out-performance are significantly diminished or unrealistic.

As a consequence, we believe that, without change, Ofgem's proposed total price control package would mean significant costs in terms of job losses, and it threatens to compromise existing standards of service going forward and is therefore a bad deal for customers.

Here are our comments on the package of proposals set in the context of Ofgem's objectives for the review as listed at paragraph 2.6:-

Ofgem objective: providing appropriate incentives to DNOs to develop and operate their networks in an economic, efficient and co-ordinated manner.

Incentives for developing the network
Although we believe Ofgem's proposed capex allowances are still insufficient, Ofgem has at least broadly recognised our cases for increased capital investment. In addition, Ofgem's proposed sliding scale mechanism for capex will add some welcome flexibility, enabling us to develop the network in accordance with Ofgem's objectives.

However, as explained in our main response, we remain concerned that Ofgem's proposed cost of capital is too low, believing that the proposal takes insufficient account of DNOs' reduced opportunities to out-perform, the dividend growth model and market expectations.

We contend that, unless Ofgem raises 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.

Incentives for operating the network
The opex efficiency incentive proposal, which would allow companies to keep a much smaller share of any opex savings made, will mean a significant change in the balance between shareholders and customers. As explained in our main response, we believe it would no longer be in companies' interests to invest in opex efficiency savings, and this can only be to the long-term detriment of customers.

Ofgem objective: providing clear and consistent incentives to DNOs to help ensure they provide an appropriate quality of service to consumers – including incentives for timely and efficient investment in the network.

As already stated above, we believe that the sliding scale mechanism on capex is a welcome development to deal with the inevitable uncertainties associated with 5-year investment plans. However, it is no substitute for setting allowances appropriate to network need in the first place.

We do not believe that Ofgem's proposals provide appropriate incentives for quality of supply. Our main response explains why we believe the targets and allowances for improvements in quality of supply are unconnected and consequently unrealistic. If Ofgem wishes us to improve quality of supply, it must make proper allowances available.

Ofgem objective: seeking to ensure that the DNOs can finance their licensed activities commensurate with an efficient level of expenditure.

As we have already stated, we believe Ofgem's proposed cost of capital is too low and this threatens to jeopardise attracting the funds for the required investment

We also believe that Ofgem's future opex allowances are too low, proposing reductions which are unsustainable and which will compromise DNOs' abilities to run their businesses and, in particular, to repair and maintain the network in the case of faults and severe weather.

As we have argued in our main response, we believe the benchmarking analysis underlying Ofgem's proposed allowances is seriously flawed and that the allowances proposed by Ofgem take insufficient account of increasing costs and assume unrealistic productivity improvements.

We also believe that Ofgem has treated Central Networks particularly poorly, by comparing single DNOs to merged DNOs without adjustment, and so not comparing like with like. Furthermore, we believe Ofgem's proposed allowances effectively take away merger-saving benefits before our shareholders have had their fair and expected share of them.

We contend that, if the proposals remain unchanged, DNOs will not attract the necessary investment and will not be able to operate their networks without significant deterioration in the quality of service offered to customers.

Ofgem objective: providing DNOs with appropriate incentives to connect and utilise distributed generation.

As we have said numerous times in our responses to Ofgem, we continue to have concerns about our exposure to particular high-cost projects. However, we acknowledge that Ofgem's suite of incentives for distributed generation will broadly have the effects intended.

Ofgem objective: providing appropriate incentives to help to ensure that longer term security of supply is maintained.

In spite of the direction offered by the DTi Select Committee and evidence that customers are willing to pay for such improvements, Ofgem has explicitly rejected allowing capex aimed specifically at improving network resilience. We believe this is unwise, and urge Ofgem to reconsider its position.

Ofgem objective: reflecting Ofgem's responsibilities with regard to environmental and social issues.

Ofgem has acted on some of its environmental responsibilities by making proposals for additional environmental reporting. However, as we explained in our main response, by rejecting any expenditure related to visual amenity, we believe Ofgem is failing to take sufficient account of its own and DNOs' duties under the 1995 Environment Act. We believe there is little excuse for this, especially as there is evidence that customers are willing to pay for such investment.

Costs and Benefits of the Price Control

Ofgem already has these, but has effectively ignored them because it has concentrated on base case submissions, rather than the submissions for quality of supply and DNOs' preferred cases. The quality of supply and preferred cases contain detailed work on the costs and benefits to customers. Moreover, we have consistently argued that the base case is an artificial construct and does not deliver the best value for customers. We maintain our preferred case offers the best trade-off of costs and benefits, and so is best value to customers, and we will continue to press Ofgem to set allowances in accordance with it. This will assist Ofgem in its assessment of the whole price control for it makes clear what the detailed costs and benefits will be.

2.12 Ofgem asks for the costs incurred by DNOs for the price control review.

It is difficult to assess the costs we have incurred and will incur for DPCR4. Whilst Central Networks has had core teams in both East and West working on it effectively full-time, there have been significant and varying contributions from various people throughout our business, and, of course, this has been further complicated by our re-organisation following the merger of EME and Aquila.

We have, however, attempted a "best guess". The following figures should be treated with caution, as indicators of an order of magnitude only, rather than an accurate identification of the costs we have incurred.

East	West
In excess of 10 man years - £500k plus	In excess of 10 man years - £500k plus
Consultancy £150k plus	Consultancy £250k plus

Risks and unintended consequences

2.20. Ofgem welcomes views on whether the price control is too tight or too loose and whether it achieves an appropriate balance between the incentives for output delivery and those for efficiency savings.

Central Networks believes that the overall price control proposals are too tight, in particular, that the allowances and opportunities to out-perform are too low to encourage the requisite climate for investment.

As we have said here and in more detail in our main response:

- We welcome the sliding scale mechanism for capex because it will give DNOs some flexibility for efficient investment.
- The proposed capex allowances are too low and, because they are not based on our preferred cases, they are not best value for customers.
- Ofgem's proposed opex allowances are unreasonably and unsustainably too low, and are unsatisfactory.
- The quality of service targets are unrealistic and the allowances for any quality of service improvements insufficient.
- Ofgem is taking insufficient consideration of its own and DNOs' responsibilities with regard to resilience and the environment and is not allowing DNOs to deliver out puts which customers want.

Ofgem's proposals for opex allowances and incentives are too harsh and unsustainable; they will, if unchanged, result in worsening standards of service to our customers.

Review and compliance

2.27. Ofgem welcomes views on the impact of the price controls on the level and process of review and compliance.

Our comments here are limited because it is not yet clear how existing processes will change.

The one issue we have identified so far concerns the audit for special licence condition D. Currently this is a relatively simple process in which an auditor makes a simple check of reported results against the terms and definitions in a single licence condition.

It is already clear that the new price control will be more complex than the current one, with more terms and definitions, which will be dispersed amongst various licence conditions and RIGs. Although costs per licence are relatively small in the context of the whole price control, we believe they could increase two- or threefold. Perhaps more important than the cost, is that we believe Ofgem will need to take account of the increased workload in its timetabling and setting of deadlines.

PART 2 QUALITY OF SERVICE

Costs and Benefits

3.11 Ofgem invites views on its initial proposals for quality of service, in particular attempts to quantify the costs and benefits of the arrangements.

Ofgem has introduced tougher targets since the submission of business plans along with reductions in requested allowances to achieve the targets.

Our main response explains why we believe the targets and allowances for improvements in quality of supply are unconnected and consequently unrealistic. If Ofgem wishes us to improve quality of supply, it must make proper allowances available.

Distributional effects

3.12 Ofgem invites views on the distributional effects of the proposed arrangements.

The proposed tough targets and limited allowances will drive DNOs to either fail to meet customer service targets or develop perverse solutions which fail to deliver underlying reliability improvements.

Investment programmes will, therefore, undoubtedly focus on urban networks, aiming at improving services, which urban customers already deem acceptable and at the expense of poorer performance for rural customers. It will effectively encourage "number manipulation" rather than real improvements in network performance.

We believe this is perverse. Ofgem must set incentives and allowances which enable us to address underlying network problems, rather than just symptoms.

Risks and unintended consequences

3.15 Ofgem invites views on the potential risks and unintended consequences of its proposals, including where possible quantification of the likely impact of the incentive rates proposed for the interruptions incentive scheme and the form of the scheme for telephony.

There remains a lack of clarity on key aspects of Ofgem's proposals which makes it difficult to make the kind of assessment Ofgem wants.

Annual penalties and rewards are proposed for the incentive scheme, but the mechanism for the revenue adjustments, resulting from them is unclear. It may be inferred from the proposals that adjustments to revenues will be carried out on a rolling basis rather than on a 5 yearly regulatory period. If this is the case, it will lead to some uncertainty concerning future annual revenues. This uncertainty is compounded by the nature of incentive-based reporting, where performance results are not fully collated and audited until some way through the following regulatory year. The mechanism for incentive scheme adjustments requires further clarification and we believe consideration should be given for a regulatory-review-period adjustment to revenue rather than a rolling annual approach, to reduce uncertainty and risk for DNOs, but also to minimise tariff disturbance to suppliers.

There remains uncertainty over the different thresholds for severe weather, and how they are defined will determine a DNO's risk exposure. The details of such changes need to be clear before a full assessment of the impact of the change is possible.

Performance targets need to be both achievable and adequately funded. Where targets are based upon driving towards industry best practice within short time scales, the opportunity for out-performance and thus rewards is minimal. Central Networks believes that the targets developed are unfair and severely restrict the practical range of the proposed symmetrical incentive scheme, effectively resulting in little probability of achieving rewards. This inevitably increases the risk of revenue penalties, further reducing investment capability and limiting the scope for continued network performance improvements for customers.

In terms of potential unintended consequences, as we have already said, focus on average measures in the IIP regime is likely to encourage further improvements in urban network performance. In addition, applying different weightings to planned and unplanned interruptions is likely to lead DNOs to focus more on fault restoration and neglect efforts to improve planned interruption management.

Competition

3.16 Ofgem invites views on the impact of the proposed changes on competition.

It is not considered that the Quality of Supply measures impact competition.

Review and compliance

3.17 Views are invited on the likely costs of any monitoring for the revised framework.

The costs of monitoring and auditing associated with ensuring consistency in reporting against the revised framework need to be taken into account. It is anticipated that additional reporting requirements and changes to incentives and rules will have cost implications. In particular changes in rules needs to be communicated to staff and may require some systems changes. Increase accuracy requirements need to be statistically valid and therefore require increased audit sample sizes, resulting in increased audit costs.

Questions for developing the RIA

3.19 Ofgem invites responses to a number of specific questions

Impact on other incentives within the Price Control Framework

Ofgem has allowed some capex to achieve CI improvements, but expects duration improvements to be provided through improved operational practices and hence only allowed opex. Improvements in response time, even industry best practice, can be achieved by employing more staff at more locations, but this approach is inconsistent with the expectation that companies need to operate at an efficient opex frontier. It is not feasible for all DNOs to be both low cost and best performing.

Basing opex allowances and targets on frontiers in both operational expenditure and network performance, creates a "virtual DNO" which cannot be realised. There has to be a trade-off between significant performance improvement requirements and operating costs. The proposed £1m opex allowance per annum is insufficient, within an overall framework of reducing opex, to deliver the required performance improvements.

Safety Impacts

In general, it is not considered that the proposed QofS changes have an impact on safety. However, the rejection of investment in amenity improvements and network resilience will inhibit the consequential public safety improvements from, for example, the replacement of overhead line with either covered conductor or underground cables.

Costs and Benefits of Network Resilience

The benefits of the outputs bought in terms of network resilience (i.e. improved storm reliability) need to be shaped by strategic societal guidance. Central Networks believes that wholesale undergrounding is neither practical nor cost effective. However, targeted resilience investment for predominantly underground circuits or those running through forests would significantly improve customer service during storms. Where such investment is disallowed the associated incentives and penalties need to reflect this and be fair.

Impact on long term reliability

The marginal cost allowances derived for the delivery of the proposed QofS improvements will drive DNOs to focus on short-term symptom management rather than addressing the fundamental reliability of the network. Central Networks believes that the delivery of QofS improvements is best achieved, for the long-term, through a network that is generally more reliable. However, this is driven by long-term investment plans and is a function of asset management practices and the level of capex allowances. Without significant capex investment in the network infrastructure to improve reliability, the QofS improvements will continue to be focused on short-term symptom management.

CENTRAL NETWORKS' RESPONSE TO

APPENDIX 145G
REGULATORY INSTRUCTIONS AND GUIDANCE VERSION 1 FOR DISTRIBUTED GENERATION, INNOVATION FUNDING INCENTIVE AND REGISTERED POWER ZONES

General

Central Networks welcomes the development of the DG, IFI and RPZ regulatory Instructions and Guidance to facilitate open and accurate reporting

We also welcome Ofgem's acknowledgement that the reporting burden on the DNO's for DG, IFI and RPZ data is and will become significant. This is an area of concern which we feel still needs to be thoroughly understood. The timescales for providing such data are short and the resourcing and allowed costs are still unclear.

Whilst we understand Ofgem's separation of the RIG and licence modification data into two documents, presentation has not, in Central Networks view, been altogether helpful. It increased the complexity of the analysis DNOs needed to carry out to understand the proposed changes. It would be helpful in future if the connections between documents were made more transparent, even at the expense of significant duplication.

We also believe the documentation would benefit from a glossary, providing clear definitions of key terms in one place.

Detailed Comments

The following are detailed comments on individual paragraphs.

2.3 Relevant DG

2.3 Bullet Three

'*Relevant agents'*. Central Networks is unclear what this means. This is not a commonplace term within the DNO community. If Ofgem wishes to use such a term, we believe it needs a clear definition.

The third line 'as set out in Chapter 5' should read 'as set out in Chapter 6'

It is unclear from the documentation how the incentive mechanism applies to DG connected to the networks of independent distribution licence holders operating inside existing DNO licensed areas. We believe that the "relevant agents" term is attempting to cover this, but, as we have said, this needs clarifying.

2.4 'An upgrading or expansion of a DG plant' would be more clearly and accurately expressed, for example, as 'An increase in capacity of DG plant'

2.5 Central Networks has concerns over the DG 'connection start date' in its role as the trigger for the collection of use of system charges. We are not confident that DNOs will be informed of the connection of all generation, particularly domestic micro-generation, at the time of connection. We would wish to be able to recover generator use of system charges from a generator many months, even years, after actual connection should it be necessary, when a generator has failed to inform us.

Line 4, replace 'full commercial operation' with '**agreed** commercial operation'.

2.14 Replace 'registered asset value' with 'regulatory asset value'

2.15 Central Networks opposes the introduction of a network unavailability charge for distributed generators. We believe such a charge is unnecessary and discriminatory to demand customers. If Ofgem deems some kind of charge or penalty necessary, we have proposed a more suitable and simpler charging mechanism for generators, similar to the guarantee of service penalties for customer service.

Further information on our proposal can be found earlier in this document, in our response to *Appendix 145b - Further details on the incentive schemes for distributed generation, innovation funding and registered power zones*.

2.18 Change 'full capacity' to '**agreed** capacity'.

2.23 O & M charge for DG
Like most, if not all DNOs, Central Networks would have considerable difficulty providing O & M reporting data directly attributable to DG. We do not have the reporting facilities to either collect or report such detailed information. We would however, be able to provide information on our total O & M costs during a reporting period and could develop an agreed cost apportionment rule.

6.3 Change '31 June' to **30** June