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ENERGY
NETWORKS
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Dear David

Electricity Distribution Price Control Review – Initial Proposals June 2004

Thank you for the opportunity to formally respond to the initial proposals.

You will be aware that since publication, the ENA has made a number of submissions to Ofgem on behalf of our member companies on specific topics. Of course, we had discussions immediately following the paper's publication, too. Consequently, I do not propose to comment in detail on the proposals. Instead, I would like to make a few observations upon the outstanding issues which we need to resolve over the last few months of the review, and also to touch on issues for 2005 and beyond.

Firstly, I would like to put on record my appreciation of the efforts you have made to make the DPCR4 process more transparent and better organised than I am told that the 1999 review was. Admittedly, when the DCPR4 Initial Proposals were published I was disappointed that there was a delay before our members could gain a thorough understanding of them through the release of your financial model and the consultants' opex and capex reports. I was pleased that this situation was quickly remedied via the release of this information during July. The co-operative working between the companies and Ofgem has also been of great mutual benefit and has served to further both our understandings of the key issues to be resolved. I look forward to building upon this relationship in the months to come.

The ENA's response to your March paper highlighted our concerns over your indicative proposals for the WACC, capex and opex incentives and the recovery of pension costs in relation to ERDCs. Whilst we are working towards the resolution of these issues, the June paper has raised further concerns, notably in relation to the very demanding opex targets which have been set for our Members. Specifically, we believe the requirement for DNOs to outperform the general productivity of the UK economy (1.3%) by 2% per annum is excessive and unrealistic given the huge strides companies have already made in eliminating costs and the limited scope that we believe that there is for further improvements. However, I trust that further discussions between ENA, the companies and yourselves (together, perhaps with consideration of Ofwat's approach to these issues in their recent Draft Determinations) will enable a satisfactory compromise to be reached on all of them before your final proposals are published in November.

I recognise that after the conclusion of the review, there will still be a number of areas which will require further collaborative work and where ENA is keen to be involved. These range from topics where we have identified shortfalls in our mutual understanding – such as the key drivers of network performance, measures of network resilience etc, to issues where we have collectively identified that significant improvements are necessary in the review process itself, notably in the collection of cost data, the RAGs etc. There is also of course the planned review of the DPCR4 process early in 2005, as well as the forthcoming price reviews of the electricity and gas transmission companies and the likely sale of the LDZs later in the year.

A further body of work which we must also consider is how to adapt the current regulatory framework to accommodate the changing national and international energy environment. Prior to 2004, it always looked as if DPCR4 was going to require a departure from the traditional RPI-X approach to network utility regulation in order to accommodate these developments, and in particular the Government's energy policy objectives for renewable energy, energy efficiency and security of supply. In the event, slower than expected progress in these areas has given us the breathing space to consider them in more depth and DPCR4 has essentially been based on the traditional regulatory model with a few add-ons in relation to incentives for the connection of distributed generation, strengthened incentives to reduce losses and potential re-openers to accommodate known developments (ESQCR and TMA) where the precise impact upon companies is as yet unclear. This is unlikely to be appropriate for DPCR5.

It is important therefore that we begin to think about how we might manage this process of adapting the regulatory framework whilst at the same time ensuring the network companies continue to provide the high levels of service to which their customers have been accustomed. The long term charging review for use of system, the review of distribution governance and the implications of BETTA on the transmission network companies in particular will be important in this respect as well of course as the growth of renewable, and in particular, distributed generation arising from the Government's own energy policy objectives.

I intend to set out my thoughts in more detail on these longer term issues in response to Sir John Mogg's recent open letter inviting comments on Ofgem's three year strategy 2005-2008. Meanwhile I look forward to continuing to work with you and your team until the conclusion of the Review at the end of the year and in particular to our rescheduled meeting with Alistair Buchanan on 24 September.

Yours sincerely

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