Our Ref:

Your Ref:

Date: 25 October 2004

Mr M Crouch
Director – Electricity Distribution
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Dear Martin

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW:
UPDATE PROPOSALS – SEPTEMBER 2004**

I attach the response of CE Electric UK Funding Company, Northern Electric Distribution Ltd and Yorkshire Electricity Distribution plc to the Ofgem *Update proposals*.

You will see that most of the points made in this response were covered in the early version of the Executive Summary that we sent to you. We have also discussed many of these issues at our meeting with the sub-committee of the Authority on 14 October and subsequently with you, David and Carl on 20 October.

If there are any points on which you would like clarification please let me know.

Yours sincerely,

John France
Director of Regulation

Enc.

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CE Electric UK

ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW:
UPDATE PROPOSALS - SEPTEMBER 2004

The response from CE Electric UK Funding Company (CE), Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL)

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Electricity Distribution Price Control: Update proposals - September 2004

The response from CE Electric UK Funding Company (CE), Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

Set out below, are the views of CE, NEDL and YEDL in response to Ofgem's publication *Electricity Distribution Price Control: Update Proposals, September 2004* (the *Update proposals*).

In the Executive Summary below, we first highlight the company-specific issues followed by the significant industry-wide issues that need to be addressed prior to publication of the *Final proposals* in November.

The main body of our response then follows and is set out in the same order as the *Update proposals* consultation document.

EXECUTIVE SUMMARY

We recognise the improvements that have been made in the *Update proposals*. This response concentrates on those areas where we believe further improvements need to be made.

The *Final proposals* must correct the serious errors that we have identified, make sure that all previous commitments are honoured and improve any detailed factors where the *Update proposals* are weak and unsubstantiated.

Company specific issues

YEDL is still being unfairly treated in the Update proposals.

We remain concerned that YEDL is still being treated disproportionately, as is shown by:

- Po comparisons;
- simple benchmarks of revenue and cost allowances per customer; and
- a comparison of the way that specific allowances have stretched the opex benchmarks for other companies compared to YEDL.

The *Final proposals* must recognise YEDL's total cost efficiency and make an additional allowance to achieve parity of treatment with other DNOs.

The calculation of pension costs needs to be adjusted to reflect Ofgem's principles...

We have provided clear and detailed evidence to Ofgem, that has not been refuted, showing that:

- the deficit should be allocated 56:44 between NEDL and YEDL; and
- 93 per cent of the NEDL deficit relates to the distribution business.

The *Update proposals* do not yet reflect the requirement that the allocation of the deficit should not result in any cross subsidy. Moreover, it is inappropriate that the annual pension deficit payment should be reduced by 1/13th for 2004/05 contributions.

...and further adjustments are needed to correct errors in the tax allowances.

The principle of avoiding cross subsidy also requires adjustments to the tax calculation since the opening pool of capital allowances retains historic elements from non-distribution activities.

The *Update proposals'* assumption on the allocation of capex in the DPCR3 period and the assumption for non-load allowances in the DPCR4 period result in an overstatement of the capital allowances to be claimed in the DPCR4 period. Overall, Ofgem's assumption of the tax payable by NEDL and YEDL in the DPCR4 period is significantly understated.

Our capital allowances are still too low...

We note the increase in capex allowances since the *Initial proposals*. However, these movements are insufficient to meet the case that we made to Ofgem. Despite NEDL and YEDL being found to be efficient, the *Update proposals* still imply a shortfall against our capex requirements for the DPCR4 period. Our opex forecast is dependent upon our capex forecasts being allowed in full.

... and the sliding scale needs re-calibration.

We have submitted analysis that demonstrates the need to increase the return component of the sliding scale to ensure that a risk averse management is properly incentivised to forecast capex accurately.

The Final proposals must give effect to Ofgem's commitment in respect of opex out-performance in 2003/04 and 2004/05.

Ofgem made a commitment that DNOs would be allowed to retain for five years the benefits of incremental opex efficiency savings achieved in 2003/04 and 2004/05. The March 2004 *Policy document* set out how the incentive payments would be calculated and added to income in the DPCR4 period.

Notwithstanding this unequivocal commitment, no amount has been factored into the DPCR4 allowances in the *Update proposals*. It is unthinkable that Ofgem would resile from this commitment (on which we and other DNOs have relied) and therefore an additional revenue allowance must be factored into the DPCR4 period allowances.

The unit growth factor of 1.8 per cent used for NEDL is too high.

The composite growth factor (i.e. units and customer numbers) assumed by Ofgem for NEDL is higher than the factor being used in all other areas of the country except London. This seems to be implausible and should be reset to 1 per cent.

Industry-wide issues

The cost of capital proposed in the Update proposals is currently inadequate.

We support the all-DNO response that a cost of capital at the top end of the range quoted by Ofgem is needed to secure investment in the sector.

The Update proposals strip out future savings before they have been achieved...

Whilst we welcome the reduction in the opex frontier shift from 2 per cent to 1.5 per cent per annum, Ofgem is still anticipating efficiencies before these have been achieved. We do not believe that this is justified.

...and no allowance has been made for re-structuring costs.

The reward for opex efficiencies will be lower in the DPCR4 period as a result of the equalisation of opex and capex incentives, yet no allowance has been made for the costs that will be incurred in achieving efficiencies. The absence of pension fund surpluses increases the effective cost of redundancies to the business. Together these changes alter the cost/benefit calculation for any efficiency gains that require up-front investment. The *Final proposals* should therefore relax the frontier shift assumption and/or the opex out-performance mechanism should allow implementation costs.

Ofgem should clarify the incentive mechanisms to be used in DPCR4...

More clarity is needed on the detailed mechanics of the opex/capex incentive equalisation mechanism and on the tax efficiency incentive mechanism before companies can properly consider the *Final proposals*.

...and should provide a clear commitment to review and improve incentives during DPCR4.

We support Ofgem's intention to produce Regulatory Instructions and Guidance (RIGs) for cost reporting and we agree that this work is essential for consistency. In completing this work we also expect Ofgem to honour its commitment to review and improve the strength of efficiency incentives at the earliest opportunity during the DPCR4 period.

The Electricity Safety, Quality, Continuity Regulations (ESQCR) have cost implications during the DPCR4 period which are currently not catered for.

We welcome the commitment to fund efficient levels of investment for programmes to comply with Electricity Networks Association (ENA) TS 43-8 but submit that further clarity over funding is required. The issue of ESQCR compliance encompasses issues such as modifying networks to provide customer earth terminals, remediation of high-risk substation and overhead line sites and fused neutral cut-out replacement. The *Final proposals* should allow for these costs.

The severe weather events standards should have an exponential escalation mechanism and an upper limit needs to be applied to limit the scale of event to which the standards apply.

The escalation mechanism above the very large event threshold must reflect the non-linear nature of the impact on distributors, the levels of available resources, and need to maintain safe working practices. It is also important to limit the risk to which the DNOs are exposed, as in the existing arrangements, by having an upper threshold no greater than the equivalent of 50 per cent of exposed customers.

More detail is needed on the metering price control prior to the Final proposals.

The *Update proposals* leave several important aspects of the treatment of metering uncertain, particularly with respect to revenues under the new price control. Until we see more concrete metering price control proposals we cannot be confident that this element of the package will be acceptable.

The financial model should use the mid-year approach for the NPV calculations.

We support the ENA position that Ofgem should continue to apply the 'mid-year' approach in the NPV calculations used to set allowed revenues as a more logical approach than the alternative 'end-of-year' approach.

...and, finally, the distributed generation (DG) hybrid funding mechanism needs updating.

The DG hybrid funding mechanism should be recalibrated to reflect movements in the charging boundary and the post-tax cost of capital.

ELECTRICITY DISTRIBUTION PRICE CONTROL:

Update Proposals – September 2004

The response from CE Electric UK Funding Company (CE), Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

Set out below, are the views of CE, NEDL and YEDL in response to the *Update proposals*. The response broadly follows the form of the *Update proposals*.

1. METERING (Chapter 2)

1. We recognise that significant progress has been made on determining the way forward for the metering price control since the publication of Ofgem's *Initial proposals* in June. However, there are a number of important issues that remain outstanding and time is very short if there is to be proper consultation on these before the publication of the *Final proposals* in November. With this in mind, we support the proposals for resolving these important issues as set out in the 19 October 2004 ENA letter to Ian Osborne, *'Initial metering proposals contained within Ofgem's September Update'.*

1.1 METER ASSET PROVISION (MAP)

(Paragraphs 2.7 to 2.22)

2. We require improved clarity on the proposed price caps for MAP in order to provide increased certainty on the income that will be generated under the new price control.

3. With respect to the proposed mechanism for cost recovery, we believe that it acts in a perverse manner in that a supplier who chooses to use an alternative technology to that provided by the DNO is allowed to terminate the arrangement with DNOs without incurring any costs; meanwhile the suppliers who have not chosen such a route are left with increased costs.

4. We contend that the use of termination charges is the only mechanism that ensures that the person who is causing costs to arise is liable for paying them. There is no reason to suppose that they represent a barrier to competition, and it is entirely consistent with the sorts of protection that competitive non-DNO asset providers will put in place.

1.2 METER OPERATION (MOp)

(Paragraphs 2.23 to 2.36))

5. Clearly, there is still considerable effort required to complete the work on MOp, particularly with respect to the analysis of the appropriate revenue driver. We therefore have insufficient knowledge of the full implications of any changes even at this late stage of the review process.

2. QUALITY OF SERVICE AND OTHER OUTPUTS (Chapter 3)

2.1 INTERRUPTION TARGETS

(Paragraphs 3.3 to 3.10)

6. We note that Ofgem has now recognised the differences inherent in the Manweb HV network and has applied a different target setting methodology in their case. Taking this forward, we believe that Ofgem should also exclude Manweb's HV underground performance when deriving the benchmarks for other DNOs.

2.3 SEVERE WEATHER EVENTS STANDARD

(Paragraphs 3.25 to 3.39)

7. Our only remaining concerns with the proposed severe weather events standard are with the treatment of category 3 events and these are summarised below:
   - the escalation mechanism proposed does not appropriately account for the exponential impact of an increasing scale of severe weather events; and
   - there is no upper limit to the scale of event to which the standards apply.

8. We support the solution proposed in the 7 October 2004 ENA letter to Martin Crouch, *'Policy Issues Concerning Very Large Severe Weather Events'*:
   - Any escalation mechanism above the very large event threshold must reflect the non-linear nature of the impact on distributors, the levels of available resources, and the need to maintain safe working practices. We have proposed a square law approach that would be acceptable when combined with an upper limit to the scale of an event for which compensation is made.
   - There must remain a limit to the nature of an event for which a DNO should be expected to compensate customers for failure to deliver a prescribed level of service. The existing instrument is important in limiting risks to which the DNOs are exposed and we consider that there should remain a reasonable upper threshold, no greater than the equivalent of 50 per cent of exposed customers.

3. COST ASSESSMENT (Chapter 4)

9. We welcome the movement from the *Initial proposals* to allow our opex forecast in full and to narrow the gap to our capex forecast. However, these moves do not yet go far enough to recognise the risk/reward balance and the total cost of overall performance.

10. YEDL has been given a disproportionate treatment across the board, specifically reflected in terms of allowed revenue per customer. This leaves YEDL exposed, relative to its plan, and treated unfairly relative to the sector on the risk/reward

balance. We therefore require an increase in YEDL's allowed revenue to address these issues.

11. There is a wide range of allowed revenues across the sector. This degree of variance cannot be sustained on the basis of regional differences alone. It is inevitable that this reflects either inefficiency or higher investment to reduce risk: there is certainly some evidence that lower-spending companies are carrying higher levels of risk.

12. Our forecasts were based solely upon known cost impacts (including anticipated efficiencies), and include no contingency for further, future risks. Our cost submission was therefore based upon the settlement addressing these risks, through a combination of an effective mechanism for dealing with uncertainties and an allowed rate of return that truly reflects business risk.

13. If neither of these are forthcoming, then shading factors above our forecast become more important to restore our risk/reward position.

14. CE bears all the hallmarks of an efficient operator, with excellent safety and environmental performance and all-round cost control. This performance is as deserving of a reward as any other: indeed, it is particularly suitable for a discretionary reward, as it is not reflected elsewhere in the current framework.

15. It is clear that lower-cost companies (including, but not limited to, CE) deserve some reward to offset the additional risk they bear and/or reward their efficiency. In particular, the settlement proposed for YEDL is disproportionate, and must be offset by a recognition of YEDL's total cost efficiency.

3.1 OPERATING COSTS

3.1.1 Establishing a benchmark, glidepath and frontier shift

(Paragraphs 4.20 to 4.26)

16. We accept the use of an upper quartile benchmark provided that the future expectations of that benchmark are reasonable. Whilst we accept that Ofgem has reduced this expectation from a 2 per cent per annum reduction down to 1.5 per cent per annum, such an expectation is not justifiable, based on the findings of the CEPA study.

17. The CEPA report, referred to in the *Update proposals*, suggested a range for operating cost improvement of 0.7 per cent to 3.7 per cent per annum. This is based on a number of assumptions which are fundamentally flawed:

    - the top-end range used by CEPA is unrealistic with respect to future productivity expectations;

- there is no separation of the catch-up and frontier shift components of productivity; and
- the productivity assumptions used for the UK economy are inappropriate.

18. We support the arguments set out in the ENA letter of 8 October 2004 to David Gray, *'September Update document – ongoing opex efficiency assumptions'*, and ask Ofgem to reconsider its assumptions in this area and to reduce the expected frontier shift accordingly.

19. The reward for opex efficiencies will be lower in the DPCR4 period as a result of the equalisation of opex and capex incentives, yet no allowance has been made for the costs that will be incurred in achieving efficiencies. The absence of pension fund surpluses increases the effective cost of redundancies to the business. Together these changes alter the cost/benefit calculation for any efficiency gains that require up-front investment. The *Final proposals* should therefore relax the frontier shift assumption and/or the opex out-performance mechanism should allow implementation costs.

3.1.2 Total cost analysis

(Paragraphs 4.27 to 4.31)

20. We have consistently demonstrated that NEDL and YEDL are efficient on a total cost basis and this can be seen in the Ofgem analysis. Total cost efficiency should be recognised and rewarded in the *Final proposals*.

3.1.3 Mergers

(Paragraphs 4.45 to 4.49)

21. We agree with Ofgem that there is little merit in Ofgem adjusting the benchmarking to take into account the difference between merged companies and singletons as all companies in the comparison benefit from economies of scale to some degree, whether from merger with another DNO, merger with a gas or water business or from being positioned within a vertically integrated group of companies.

22. The *Update proposals* invite views on the treatment of future mergers in respect of the tariff for loss of comparators. We continue to be of the view that such tariffs are inappropriate and unnecessary. The case for the tariff was based on a poor assessment of the deficit caused by a loss of comparator. The current Ofgem merger tariff may also be contrary to EU law.

3.2 CAPITAL EXPENDITURE

3.2.1 Base case capex

(Paragraphs 4.53 to 4.56)

23. We welcome the movements in headline capex from the *Initial proposals*, but strongly believe that they do not yet go far enough. There still remains some unjustified disallowance of investment from both the NEDL and the YEDL efficient projections.

24. We remain in a position where we have neither a full breakdown of the PB Power assessment nor an explanation of which parts of our submission are considered by PB Power to be inefficient. We do not know what aspects of PB Power's deliberations have led them to such a conclusion, nor which alternative run of numbers offered by any other company show our approach to be less than the most efficient projection for our asset base. This is not acceptable and we therefore submit that our forecasts should be allowed in full.

3.2.2 ESQCR, resilience and worst-served customers

(Paragraphs 4.57 to 4.60)

25. While there is only a small gap to close in respect of base cost projections, the risk/reward balance has yet to be fully addressed. Specifically, in the context of capital allowances, provision must be made for ESQCR compliance, and we must be clear about expectations in respect of network resilience and worst-served customers.

26. The NEDL and YEDL capital submissions included no contingency for unknown costs, and the overall package was therefore predicated on a suitable treatment of these uncertainties. We do not believe that the *Update proposals* adequately provide for this.

27. We note Ofgem's commitment to review ESQCR costs in 2008 but contend that this commitment does not cover all costs associated with the ESQCR, some of which will occur sooner than 2008. We welcome the commitment to fund efficient levels of investment for programmes to comply with ENA TS 43-8 but submit that further clarity over funding is required as set out in the 8 October 2004 ENA letter to Martin Crouch, *'Costs associated with implementing Regulation 18 (5) of the ESQCR'.*

28. However, the issue of ESQCR compliance runs much wider than this, encompassing issues such as:

    - modifying networks to provide customer earth terminals;
    - remediation of high risk substation and overhead line sites; and

- fused neutral cut-out replacement.

29. We believe that PB Power have not considered these issues, and specifically that their modelling did not provide for this type of investment.

30. Fused neutral cut-out replacements are included within our submission and this may lead to some of the discrepancy between us, which can therefore be easily rectified. However, we have not provided for the first two items as investment need is uncertain. The first will be driven by customer requests. The second depends largely on the Engineering Inspectors' interpretation of the action required. We would anticipate that a provision of around £1m per licensee per year should cover these costs.

31. Finally, we cannot accept the statement in the *Update proposals* that the sliding-scale provides for discretionary investment on resilience and worst-served customers. It is clear that the *Update proposals* put forward a package that excludes changes to performance in respect of resilience and worst-served customers, and therefore that Ofgem deems that our networks will remain fit for purpose without such investment. The sliding-scale mechanism addresses uncertainties about the requirements of the base case: it cannot address uncertainties over required outputs.

3.2.3 Fluid filled cables

(Paragraphs 4.61 to 4.62)

32. We note that Ofgem is unable to address investment requirements in respect of fluid-filled cables until after publication of the *Final proposals* and that further consideration will be given to allowances for this category of investment.

3.2.4 Sliding scale mechanism

(Paragraphs 4.63 to 4.66)

33. We continue to support the sliding scale mechanism as a means to establish and reward efficient forecasts. The benchmarks for NEDL and YEDL should be set in line with our forecasts unless Ofgem is able to justify why certain costs have been disallowed.

34. We understand that Ofgem may consider the 105 per cent factor in the sliding scale sufficient to cover the unexplained discrepancy between our forecasts and the PB Power view. We do not agree. The 105 per cent factor is not relevant to the PB Power assessment of capital expenditure requirements. That adjustment factor is there to balance cost-risk exposures across the sector, which PB Power's cherry-picking approach does not secure. Those nearer the benchmark get higher incentives, but also face higher penalties, so the impact of PB Power being wrong about NEDL and YEDL is higher than it is for others. This demands

absolute certainty of capital requirements before disallowing investment from a forecast already proven to be reasonable.

35. We have submitted, in our letter to Martin Crouch dated 9 September 2004, analysis that demonstrates the need to increase the return component of the sliding scale to ensure that a risk averse management is properly incentivised to forecast capex accurately. We still believe this to be the case.

3.3 INCENTIVES

3.3.1 Equalising incentives in DPCR4

(Paragraphs 4.67 to 4.76)

36. The *Update proposals* identify three possible ways of equalising incentives on operating expenditure and capital expenditure, differentiated by the period over which underspends are clawed back and overspends are compensated. We believe that it is appropriate and possible for individual companies to be able to choose any one of these approaches based upon their own circumstances.

37. The detailed mechanism for implementation of the opex and capex incentive schemes must be transparent before the *Final proposals* are published, otherwise companies will not be able to asses the implications for future efficiency savings. Failing this the parameters of the mechanism need to be described in sufficient detail such that there is no ambiguity in their intended application.

3.3.2 The future restoration of efficiency incentives

38. We support Ofgem's intention to produce Regulatory Instructions and Guidance (RIGs) for cost reporting and will commit the resources to undertake this work in line with the timetable published in Martin Crouch's letter, dated 14 October 2004. We expect the successful completion of this project to enable Ofgem to restore the strength of operating cost out-performance incentives from 2006/07 onwards.

3.3.3 Honouring commitments against efficiencies in DPCR3

39. NEDL and YEDL have factored into their plans, in line with the commitment given by Ofgem, the expectation of retaining for five years the benefits of incremental out-performance in 2003/04. Our letter to Martin Crouch, dated 15 October 2004, quantified the expected benefit from this incentive commitment, which we expect to be honoured and added into allowed revenues in the *Final proposals.*

40. In February 2003 Ofgem made the commitment that incremental out-performance against the Ofgem DPCR3 assumptions in respect of 2003/04 and 2004/05 would be retained by the DNO for a full five years. It was clear from the way that this commitment was expressed – and particularly from the subsequent

publication and refinement of the spreadsheets that showed how the additional income entitlement would be calculated and factored into the income allowances in the DPCR4 period – that this benefit was to be incremental to the income allowances in the DPCR4 period that would result from the derivation of income using yardsticks that assumed 2002/03 to be the base year.

41. It scarcely needs saying that it is a very serious matter indeed for a regulatory body to be contemplating resiling from any commitment about the future treatment of efficiency gains. The incentive power of regulation rests entirely on the confidence that licensees can have in the commitments expressed by the regulator. It is quite clear that the Ofgem commitment envisaged additional income being generated from the five-year opex roller and yet the *Update proposals* make no allowance for this. We set out our views in full on this issue in our letter of 13 October 2004 to Martin Crouch.

42. This is a matter on which we feel very strongly indeed. Ofgem made a commitment and expressed that commitment in terms that admit no possible ambiguity about how the commitment would be carried out. We accepted that commitment in good faith and relied upon it in our behaviour and reflected it in our plans and in our discussions with Ofgem. It is essential that Ofgem acts to restore this allowance in the *Final proposals* for DPCR4.

3.3.4 Distributed generation incentive scheme

43. The figures quoted in the *Initial proposals* for the DG hybrid funding mechanism are still illustrative, based upon notional allowed rates of return and unit costs of reinforcement. To secure a robust settlement, the figures used in the proposed licence modifications should be recalibrated to take account of the best available information.

44. The allowed rate of return used both within the proposed licence modification and for defining the revenue driver is a pre-tax figure, currently a notional 6.5 per cent real (prior to sliding scale adjustments). Once an appropriate post-tax figure for the mainstream price control is agreed, Ofgem should amend this 6.5 per cent rate to reflect the agreed post-tax rate based on the tax allowances. For the avoidance of doubt, we still support the proposal that distributors should earn a premium of one per cent over the allowed rate for the mainstream settlement for a DG portfolio at the agreed average unit cost of reinforcement.

45. The notional average unit cost of reinforcement used to derive the revenue driver is currently £50/kW for most licensees. We recognise that this was based on a shallow charging boundary, and accept that a lower figure should therefore be used to reflect Ofgem's 'proportionate' rule. We disagree with the approach laid out in the draft licence modifications, of an unduly complex formula that deducts part of the user's contribution from pass-through capex. Instead, we submit that

the licence should be simplified so that pass-through capex reverts to 80% of the DNO's investment, and the revenue driver should therefore be recalibrated against a new average unit cost of reinforcement (we suggest something in the range of £40-45/kW).

46. Finally, as these calculations have adopted the review standard baseline of 2002/03 prices, they need to be inflated to 2005/06 prices before inclusion in the proposed licence modifications.

4. FINANCIAL ISSUES (Chapter 5)

4.1 PENSIONS

(Paragraphs 5.6 to 5.9)

47. We have written a detailed response to Ofgem on the CE specific pensions issues in letters to David Gray, dated 14 and 19 October 2004. The key points are summarised below.

4.1.1 Implication of protected persons regulation on overall pension costs

48. In addressing the revisions needed to overall pension contributions in the light of the 2004 valuation exercise DNOs will have to take account of the requirements of the Protected Persons Regulations. CE's latest advice is that this may involve a further increase above that currently being allowed. Ofgem should consider how this can be addressed in the *Final proposals.*

4.1.2 Deficit Allocation

(Paragraphs 5.10 to 5.11)

Allocation of deficit between NEDL and YEDL

49. Table A13 of the *Update proposals* shows an allocation of deficit that equates to an allocation of 83 per cent to NEDL and 17 per cent to YEDL. Ofgem's simplistic calculations do not provide an appropriate allocation between our two DNOs. We have provided evidence to Ofgem that a more appropriate allocation is 56 per cent and 44 per cent respectively.

Allocation of NEDL deficit between distribution and other activities

50. Whilst Ofgem recognise that the YEDL liability is 100 per cent distribution, the *Update proposals* continued to disallow 20 per cent of the NEDL deficit as being related to non-distribution activities. We have provided evidence to Ofgem that the non-distribution activities represent only 7 per cent of NEDL's share of the ESPS scheme liabilities. We therefore contend that the *Final proposals* should assume an allocation equivalent to 93 per cent distribution compared with Ofgem's current assumption of 80 per cent.

4.1.3 Treatment of ERDCs

(Paragraphs 5.12 to 5.5.18)

Adjustments for ERDCs funded through cash

51. The Ofgem calculation disallows a proportion of the ERDCs charged against the scheme as being an element of the deficit, which the shareholder has to bear.

52. Table A13 of the *Update proposals* makes an adjustment for the value of ERDCs charged against surplus but does not make any adjustment for ERDCs previously funded through cash. We have provided evidence to Ofgem that CE has paid cash ERDCs in the early and late 1990s and recent years at times when surplus was not available.

53. Had these ERDCs been funded from surplus then the current level of deficit would be higher. Whilst Ofgem would have disallowed 30 per cent of the increased ERDCs it would still mean that the allowed deficit would have been higher. It therefore seems appropriate that the allowed deficit should include an upward adjustment to reflect a proportion of any cash ERDCs.

54. The annual payments for deficit repair are understated by Ofgem. Actuarial advice provided to CE indicates an annual payment of 12.2 per cent rather than the 11 per cent assumed by Ofgem.

Commencement date for deficit repair

55. Table A13 of the *Update proposals* adjusts the value of the deficit by 1/13th reflecting an assumption that payments commenced in 2004/05. We have provided evidence to Ofgem that CE, in line with normal practice, will commence payments from 1 April 2005. The proposed Ofgem adjustment is therefore invalid.

Adjustment for historic scheme returns

56. Table A13 of the *Update proposals* adjusts the value of the ERDCs for the historic scheme returns. We would welcome an analysis of the returns included by Ofgem in assessing the level of ERDCs to be disallowed.

Funding of the deficit

57. Table A12 of the *Update proposals* assumes that around 60 per cent of the pension deficit payments will be capitalised. We would welcome clarification as to whether Ofgem's assumption of partial capitalisation of pension deficit costs reflects specific advice received from the accountancy profession in the light of the requirements of FRS17 and FRS15.

4.2 TAX

(Paragraphs 5.19 to 5.21)

58. The allowance for tax charges in the *Update proposals* is understated. We have provided specific details relating to CE in our letter to David Gray, dated 18 October 2004. Currently:

- the overall capital allowance pools at 31 March 2005 are overstated;
- depreciation lives are too short; and
- the allocation of expenditure across the tax pools is incorrect.

4.2.1 Opening balances and categorisation of costs for tax purposes

(Paragraphs 5.22 to 5.27)

59. The value of the allowance pools used by Ofgem is extracted from the computations submitted to the Inland Revenue for NEDL and YEDL. Because of the history these balances reflect overall group tax planning initiatives undertaken in previous years and therefore include items that are not related to the distribution business. We have therefore submitted evidence to Ofgem to show that the opening balance used by Ofgem for DPCR4 should be reduced so as to reflect only the allowances appropriate to the distribution business.

60. The standard depreciation life applied by NEDL and YEDL is 50 years for distribution assets. The annual depreciation is calculated on a straight-line basis at 2 per cent per annum. In calculating capital allowances for the non-load pool after 31 March 2005 it is this depreciation profile that will be applied.

61. We would accept Ofgem using an average life for all DNOs but we believe the average would be in the 50+ range so Ofgem's current assumption of a 40 year life needs to be amended. Assuming a move to a 50 year life results in an understatement of the tax charge.

62. For these reasons the tax charge allowed by Ofgem in the DPCR4 period is currently understated. We assume that this will be corrected for the *Final proposals.*

4.2.2 Incentives and risk sharing

(Paragraphs 5.28 to 5.30)

63. We understand Ofgem's concerns at setting capital allowances that are too low but the nature of these allowances is that they correct over time through the tax computations. This sets them apart from assumptions about the levels of capital and operating expenditure in the allowed income calculation, which are more transitory.

64. To the extent that Ofgem overstates the level of allowances claimed in DPCR4 it means that DNOs will start the DPCR5 period with a pool of allowances that is higher than Ofgem's current assumption. We are therefore concerned that Ofgem will then expect customers to benefit through these higher allowances feeding through the allowed income calculation for DPCR5, and beyond. If this were allowed to happen then customers would have received a double benefit rather than just a timing benefit. This is not appropriate or acceptable.

65. The correction mechanism needs to ensure that customers receive the benefit of capital allowances, through lower tax charges, but in such a way that they only receive that benefit once.

66. It has been emphasised that whilst a correction mechanism provides some degree of comfort (to both parties) it does not remove the requirement that Ofgem should make assumptions that are reasonable for DPCR4.

67. Ofgem has asked companies to propose some detailed requirements for the correction mechanism. In our letter dated 19 October 2004, we covered the broad principles that we believe need to be considered.

4.3 FINANCIAL PROFILES

(Paragraphs 5.53 to 5.61)

4.3.1 Financial modelling – NPV calculation

68. During the consultation on the financial model it appeared that the 'mid-year' approach was to continue to be applied in the NPV calculations used to set allowed revenues. However, the financial model that accompanied the *Update proposals*, revealed a change to an 'end-of-year' approach.

69. We support the case presented in the 7 October 2004 ENA letter to Martin Crouch, *'Comparing the two Approaches to NPV Calculations'*, that the 'mid-year' approach is a more logical approach than the end of year approach because:

- RAV depreciation would seem to be incurred mid year, rather than at the end of the year;
- RAV return would also seem to be incurred mid year, rather than at the end of the year; and
- The mid year approach avoids capex having a cost other than depreciation.

4.3.2 Unit growth projections

70. We were surprised to find that the financial model uses a unit sales growth rate of 1.7-1.8 per cent for NEDL. Our original submission of 1.0 per cent should be

used, as it is consistent with the sector and with independent forecasts of economic growth in the north-east.

71. While we recognise 1.7 per cent as the figure derived by PB Power as a proxy for underlying cost drivers in their load-related expenditure (LRE) model, it has no relevance to forward sales forecasts.

72. As we explained in detail when reviewing the draft PB Power capex report, headline sales volumes are only distantly related to LRE drivers, due to issues such as churn, regeneration initiatives, and speculative investment by developers. We also understand from PB Power that different companies treat these issues in different ways, in both commercial policy and in reporting and forecasting investment need.

73. Comparing Cambridge Econometrics' forecast of average annual (Gross Value Added) GVA for the period 2005-10 with the compound annual growth rate (CAGR) of the revenue growth assumptions in the *Update proposals*. NEDL's disproportionate treatment is obvious. The north-east has the lowest projected GVA growth, yet the *Update proposals* assume revenue growth significantly higher than the average and second only to EdF-LPN. The comparison also shows that our projection of 1.0 per cent per annum is more than reasonable, and a figure nearer 0.9 per cent could easily be justified.

4.4 COST OF CAPITAL

74. Ofgem has not provided an update on the cost of capital in the *Update proposals* but has given an undertaking to take into account further input in this area prior to publication of the *Final proposals* in November.

75. We are concerned that the cost of capital is set at a level below city expectations, academic evidence and other regulatory settlements. Ofgem has proposed a framework for the next price control to encourage efficient investment in the distribution network of the UK and the final element of this package (the cost of capital) must attract finance into the sector. In order to attract the level of investment required, the cost of capital must at a minimum be at the top of the range previously published by Ofgem.

76. In July, the ENA provided a paper, which we supported, summarising the evidence to support a cost of capital at the top end of the Ofgem range – 5.0 per cent fully post tax. This contained the following evidence:

- **City Expectations -** quotes from Andrew Wright, Martin Brough and Philip Green all indicating that the mid-point range was too low to attract equity investors and as a minimum a number at the top of the range was required;

- **Academic Research** – reports from both Oxera and Nera have been provided to support the top end of the Ofgem range either utilising the CAPM model or the dividend growth model; and
- **Comparisons With The Water Sector** – Oxera have provided a report indicating that the electricity industry faces similar, if not more, regulatory risks. Yet OfWAT are setting a higher cost of capital, this will make the water sector more attractive to potential investors.

77. The Oxera papers show that the regulatory settlements in other sectors have been above the top end of Ofgem's range when these sectors have faced increased investment programmes. Indeed, the recent report by Ofcom on BT on a like for like basis suggests a fully post tax cost of capital of at least 5 per cent.

78. Since the publication of the *Update proposals* Ian Marchant wrote on behalf of the Chief Executives of the DNOs to expand on the above points and the ENA Finance Group have also written specifically on the relevant change in law clause. We do not repeat the points made in that correspondence in this response but confirm that we fully support the points that have been put forward. In addition, Philip Green (Merrill Lynch) has been reported as describing the cost of capital at 4.6 per cent as "unacceptably low" and "too low to incentivise investment in the distribution networks".

79. To further support our position we would make the following points:
    - Ofgem argues that the pension ERDC adjustment de-risks the DNOs – we would remind Ofgem that it actually represents a realisation of a risk, relative to investors' expectations;
    - it is widely accepted that opportunities to out-perform on operating costs are reducing, and Ofgem has not tabled evidence to the contrary – yet the proposals still strip out benefits before they are enjoyed – to a far greater extent than OfWAT is anticipating;
    - Ofgem appears to be contemplating a u-turn in respect of a clear regulatory commitment to preserve operating cost gains through the rolling opex mechanism;
    - we are poised to take on increased performance risk through the IIP scheme against targets which we believe have been inadequately funded through capital and operating cost allowances;
    - in our case, our YEDL network continues to perform as the most robust in the country which results in YEDL benefiting less from exemptions that insulate weaker performing networks;
    - the storms and atypicals allowance has made little or no assessment of the real prospect of flooding risk to our assets; and

- the uncertainty mechanism is less protective of cost-shocks than the OfWAT uncertainty mechanism.

80. We therefore encourage Ofgem to provide the final component of the framework that will promote efficient investment in the distribution networks by providing a fully post tax cost of capital of 5 per cent.

APPENDIX – Register of letters submitted prior to this response

The list below itemises all the letters sent to Ofgem by CE, plus all the ENA letters supported by CE, in relation to the *Update proposals*.

Ref	Subject / Title	Date	From	To
1	**Metering**			
1.1	Initial metering proposals contained within the September Update	19/10/04	ENA – Andy Phelps	Ian Osborne
2	**Quality of Supply**			
2.1	Policy issues covering very large severe weather events	7/10/04	ENA – Andy Phelps	Martin Crouch
3	**Cost assessment**			
3.1	Sliding scale mechanism for capital expenditure	9/9/04	CE – John France	Martin Crouch
3.2	September Update document – ongoing efficiency improvements	8/10/04	ENA – Andy Phelps	David Gray
3.3	Ofgem's commitment in respect of the five year retention of opex outperformance in 2003/04 and 2004/05	13/10/04	CE – John France	Martin Crouch
3.4	Rolling opex out-performance in respect of 2003/04	15/10/04	CE – John France	Martin Crouch
3.5	DPCR4 Opex Incentives	30/09/04	ENA – Andy Phelps	David Gray
4	**Financial Issues**			
4.1	2004/05 pensions contributions	5/10/04	ENA – Andy Phelps	David Gray
4.2	Pensions (removal of 1/13th adjustment in respect of 2004/05 contributions)	14/10/04	CE – Ken Linge	David Gray
4.3	Pensions (allocation of deficits between NEDL and YEDL)	14/10/04	CE – Ken Linge	David Gray
4.4	Pensions	19/10/04	CE – John France	David Gray
4.5	Taxation	18/10/04	CE – John France	David Gray

Ref	Subject / Title	Date	From	To
4.6	Cost of capital	03/10/04	ENA SIG– Ian Marchant	David Gray
4.7	Ofcom cost of capital	18/10/04	ENA – Andy Phelps	Martin Crouch
4.8	Relevant change of law – impact on the cost of capital	19/10/04	ENA – Nick Goodall	Martin Crouch
4.9	Comparing the two approaches to NPV calculations	7/10/04	ENA – Andy Phelps	Martin Crouch