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Dear David

Distribution Price Control – September Update

I attach Central Networks' full response to Ofgem's September Update document. As we said in our "executive summary" response of 11 October and in our subsequent meeting on 13 October, we continue to have several concerns with the updated price control proposals.

In particular, three of our concerns, opex incentives, opex allowances and cost of capital, are key, and it is essential we see some favourable change in Ofgem's position on these issues in November.

Opex Incentive Framework for DPCR4

The proposal to equalise opex and capex incentives, first mooted in March 2004 and developed into a detailed proposal in May 2004, materially weakens the opex incentive and will have major implications for behaviour. It will lead to much lower efficiency savings, higher costs and higher prices: this cannot be in the interests of current or future customers. It could also result in more short-term-focused opex-based solutions and produce a need for the regulator to monitor companies' actions in detail. Ofwat, whose regime expenses both opex and replacement capex because of the definition problem, inspects asset management plans and outcomes. The promise to restore incentives at some point in the future, after a consistent cost framework has been established, also perversely introduces "gaming" as companies potentially store up savings for the future.

Ofgem's proposals represent a disproportionate reaction to the issue that it is trying to resolve, of attaining consistency in cost reporting, and will radically alter the substance of the price control. These proposals strike at the heart of incentive regulation and RPI-X and represent a substantial move towards rate of return regulation. To make such a fundamental change at this late stage in the process has particularly profound implications for

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Central Networks as it makes significant investment in a change process to remove duplication and drive through best practice. This investment is entirely compromised by the current proposals, and is inconsistent with our legitimate expectations in relation to the treatment of efficiency savings, based on Ofgem's initial conclusions on developing monopoly price controls (June 2003). For the avoidance of doubt, Central Networks cannot accept any weakening of the opex incentive and we support the letter sent by the ENA on this issue on 30 September 2004.

Proposed Way Forward

We continue to strongly support Ofgem's intention to establish a consistent cost reporting framework, which will significantly improve benchmarking at DPCR5. Central Networks will commit the necessary resources to facilitate putting the RIGs in place by 31 March 2006. However we fundamentally oppose the proposal that this be directly linked to a significant weakening of opex incentives until Ofgem is satisfied that consistent reporting has been achieved. Instead we propose:

- Central Networks will discuss with you the detailed rules and processes used for 2002/3 data as adjusted by your normalisation and specified DPCR4 adjustments and commits to continue to apply those rules and processes across the period of the price control.
- Central Networks' continued application of those rules (i.e., its commitment) would be subjected to formal external annual audit each year; and
- Central Networks will work proactively with you, within a "reasonable endeavours" framework, to agree a framework with all DNOs for comparing costs in future.

Operating Cost Allowances

Ofgem's benchmarking process continues to have serious flaws and remains unfair and discriminatory to singletons

We have previously demonstrated that Ofgem's benchmarking processes do not address the issue of DNOs which were unmerged or late-merged and we remain disappointed that the currently methodology continues to ignore many of the positive proposals that we have made. One of Ofgem's suggested methodologies has the effect of basing the singleton allowance on one company (i.e. Central Networks East) as a frontier company and the other three singletons are assumed to need to match its costs. This is different from the impact on merged entities, which do not have to match the least cost company, and is contrary to Frontier Economics'

recommendations (March 2003), which argued against setting allowances according to any one company's costs.

The upper quartile in a group of four companies is not the lowest cost one since that quartile occupies the range 0% to 25%. The quartile is between the first and second companies. We note Ofgem's recognition that it may be the case that "non-merged entities will take longer to achieve efficient cost levels", and propose a way of addressing this.

Proposed Way Forward

Ofgem should set the singleton benchmark according to the upper quartile (midway between the most efficient and second most efficient singleton)

Ofgem continues to rely excessively on regression alone

Evidence presented by Professor Weyman-Jones and Geoff Horton continues to highlight the low levels of confidence of the upper quartile regression approach, and we remain concerned that too much reliance is being placed exclusively on regression. This bias is then compounded by a simplistic and overly aggressive productivity assumption which ignores the significant catch-up required to the uncertain frontier and the increasing cost pressures facing the industry.

We support the ENA's letter of 8 October 2004 and point out from this that:

- To add movements towards the frontier to normal growth is to double-count them.
- The DNOs are implausibly assumed to have virtually frontier efficiency (and not to earn profits that would be appropriate to that level of efficiency).
- The industry productivity growth rate implicit in Ofgem's proposals for 2003 to 2005 is implausibly large (in excess of 10%).

Proposed Way Forward

- Ofgem adopts the policy of choosing the higher efficiency score from DEA (assuming varying returns to scale) and regression for a 9 group analysis of operating and total costs. This mechanistic approach follows the DPCR3 precedent, where inefficiency was taken as the "lesser reduction from the PKF revised report and the regression analysis" (Dec 1999, p.21). A 14 DNO analysis is discriminatory to singletons and should not be used to assess our "efficient" cost level,

- A realistic but challenging assumption for opex productivity growth going forward is 0.5% p.a.,
- As at previous reviews, take into account actual costs as well as equation results and allow a realistic glidepath to the frontier.

Cost of Capital

To attract funds into the electricity distribution sector Ofgem will need to raise the proposed cost of capital. The cost of capital Ofgem has previously suggested of 6.6% pre-tax real, 4.6% post tax, is inadequate and will lead to less investment than customers require and deserve.

Ofgem has failed to properly take into account the following:

- *Investment Needs* – Independent studies at an industry level and our own plans show that investment levels are increasing significantly over the period and that the new-investment-to-RAV ratio is higher, at 52%, for electricity distribution than for water, at 44%.
- *Asymmetry of Risk in Judgements on the Cost of Capital* – Whilst we accept that, if the figure is too high, shareholders will earn too much and prices to customers will be too high, we would suggest that the implications of the converse, i.e., if the figure is too low, is far more significant. There is likely to be underinvestment and an overall economic loss as well a change in distribution of benefits between the parties. This is a particularly serious risk at the present time when such a large investment programme is needed. Admittedly, it is in our interest to say so, but it is still the case that one should err on the high side in estimates of the cost of capital. There are precedents for this position in UK Rail regulation (October 2000) and New Zealand Gas Industry (May 2004).
- *Financeability* – Ofgem wants a credit rating that is comfortably within investment grade rating yet is penalising companies with a gearing rate lower than 60%. The implied gearing rate for Central Networks rises through the period and is more likely to attract a B rating. Ofgem cannot rely on the balance sheet strength or otherwise of parent companies and needs to ensure that the licensees themselves are fundable. Ofwat has addressed this issue with an uplift for financeability and Ofgem should do likewise.
- *Equity Investment* – Ofgem suggests that it wishes to retain equity funding, but in a competitive market place funds are more likely to flow to other sectors such as water. 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.

- *Increased Risks and Reduced Out-performance Opportunities* - Ofgem's proposals increase the financial exposure to operational performance and storms and at the same time use a statistically flawed upper quartile cost benchmark. In addition new challenges like Distributed Generation and the need for substantially increased investment make the sector significantly more risky than previously. We do not accept Ofgem's hypothesis that allowing a portion of validly incurred ERDCs reduces risk for companies.
 - *Market sentiment* - the feedback we have received from analysts clearly suggests that they believe Ofgem's final proposals for cost of capital should be higher than that proposed so far, in line with the proposals in the water industry. They cannot understand the rationale for any difference.
 - *Comparisons with Other UK Regulators* - Ofgem also mentioned in their analysts' presentation comparisons with regulators other than Ofwat. CAA and ORR are regulatory precedents, which have used a cost of capital above the mid-point of their ranges. There has also been a recent report by Ofcom, published 30 September 2004, which concludes that the nominal pre-tax cost of capital for BT is 13% (6% fully post tax, real). Adjusting to a 60% gearing assumption, this gives a post tax, real WACC of around 5%, assuming no increase in the equity beta from this increased gearing. Again, this is broadly supportive of the Ofwat numbers and the top end of the Ofgem range.
- (1) We and other industry parties have sent you a number of studies and views demonstrating the need for a higher cost of capital. We have had no response from you on these specific suggestions. In addition to the points raised above we fully support the ENA's cost of capital letter of 8 October.

Proposed Way Forward

Cost of capital should be set at 7.2% pre tax real, the top of the cost of capital range proposed in the March document.

Other Areas of Concern

We still have issues with other aspects of the proposals which we detail in the attached full consultation response. Here we draw your attention to the following:

Vegetation Management

The requirement for vegetation management, particularly in the vicinity of LV overhead lines, has been strengthened by the ESQC Regulations. It is vital, therefore, that this activity is funded in line with the Central Networks' submissions to ensure compliance with the Regulations and maintenance of safety to the public.

Capex

We remain disappointed that Ofgem continues to discount the preferred cases of both CNE and CNW. In so doing, it is foregoing capital programmes that make improvements to network resilience in rural areas, and other projects that provide valuable amenity and environmental benefits.

Furthermore, a number of important elements of our base case submissions have not been supported. These programmes relate to safety, reliability and security compliance. In particular I would highlight:

- The need for investment to replace LV overhead networks in CNW to start replacing assets with implied asset lives of over 200 years;
- The need to replace overstressed switchgear in CNE.

We look forward to discussing these issues further at the GEMA meeting on 26 October.

Yours sincerely



Bob Taylor
Managing Director

Central Networks' Detailed Comments on Ofgem's September 2004 Update Document

The following detailed comments are structured to follow the order and numbering of Ofgem's document. Where we have needed to refer to the pre-merger entities, East Midlands Electricity or Aquila (Midlands), we have used the following abbreviations, CNE and CNW respectively.

2. Metering

We continue to have real concerns that the progress on metering will not deliver a sensible outcome by the end of November. The danger is that the process is expedited but the outcome is not in the best interests of consumers.

Meter Asset Provision

2.7-2.9 Standardised MAP Charges

[Ofgem proposes four price caps, one for a standard single rate meter and three for the different types of prepayment meter.](#)

Central Networks supports the proposal to set price caps that apply to all DNOs, as this removes market uncertainty and will drive further efficiencies. We are concerned however, that the proposed split of price caps for differing prepayment technologies will lead to greater risks of stranding of assets for DNOs who offer more than one prepayment technology. This will substantially increase costs in the industry and, as explained in 2.17-2.22 below, will result in unrecovered investment for the DNOs concerned. We believe there should be a single average price cap for prepayment meters.

2.10-2.13 Change to Asset Recovery

[Ofgem proposes a change to the calculations underlying the price caps, based on straight line depreciation of the purchase value of meters.](#)

Central Networks welcomes Ofgem's recognition that the mechanism detailed in the June proposals provided insufficient return on meters. However, the current proposal to use a straight line basis still does not provide the necessary return. The use of a straight line basis for both depreciation and rate of return ignores the true funding cost. An annuity-based mechanism, taking account of the timing of cash-flow, would be more appropriate.

2.14-2.15 Changes to allocation of Operating Costs and Overheads

[Ofgem proposes to allocate opex and overheads on a flat rate, calculated by dividing total opex and overheads by the number of meters.](#)

Central Networks agrees with the approach of allocating opex and overheads on a flat rate as these costs do not vary with the value of meters being provided.

2.17-2.22 Prepayment Meters and Prohibition on Termination Charges

Ofgem proposes to reduce the impact on DNOs from stranding of prepayment meter assets by means of price control adjustments but is not proposing to allow the use of termination charges to recover investment.

Ofgem has recognised that financial drivers may make suppliers change to different prepayment technologies and that this will lead to the stranding of investment made by DNOs as a result of regulatory obligation. Ofgem's suggested remedy for stranding will not reduce it; on the contrary, it will actually increase the incidence of stranding and its financial impact. Moreover, the proposal to increase meter price caps for those suppliers who are not responsible for early removal of meters is essentially unfair. In effect, Ofgem's proposals will penalise suppliers who are not in a position to make the financial investment in new technology, and this will lead to a distortion of the market and further stranding resulting from the price increases of the adjustment mechanism.

Central Networks, supports the ENA position on this, believing that any supplier who takes a commercial decision to change prepayment technologies must bear the full and fair cost of that decision. Consequently, rather than penalise suppliers in general, the only approach, which is both equitable for suppliers and allows DNOs to recover investment made as a result of regulatory obligation, is for the DNOs to be able to levy a termination charge for any meters removed before the end of their useful lives. Such a charge will be solely to recover any future revenues lost as a result of the individual supplier's actions.

If Ofgem continues to disallow the application of MAP termination charges, then any stranding must be reflected back into the general Use of System price control. This will ensure that the DNOs recover costs they were obliged to incur as part of a licence condition, whilst not accelerating further stranding of the remaining meters through meter price increases. Although this retains some unfairness for suppliers unable to change their preferred prepayment technology, it would at least be less marked because price increases would be spread over all suppliers.

Meter Operation

2.23-2.29 Methodology and Revenue Caps

Ofgem proposes revenue caps for DNOs based on an analysis of costs and a 1.5% mark-up.

Central Networks has always believed this form of control is too complex. Ofgem's lack of real progress to date in trying to formulate an average revenue cap reinforces this view. The absence of detail behind the published numbers and the lack of clarity surrounding the drivers makes it impossible for the DNOs to establish, even at this late stage, expected revenues from April 2005. We believe that unless Ofgem is in a position to publish the full detail of the proposal by the end of October a much simpler approach should be adopted. Price caps for a few service lines with a non-discriminatory approach to pricing the others, similar to the approach used in MAP, would lead to a simple control which would provide a straightforward transition to a competitive market.

In setting the control a more appropriate margin should be applied, as this is not a capital business and does not benefit from return on assets. A similar competitive business would look to operate on margins of at least 10% and therefore the proposed 1.5% mark-up is an

inadequate return likely to deter current and new entrants and hence stifle competition for the foreseeable future.

2.30 Inclusion and Exclusions

Ofgem lists a number of activities not covered by the proposed price control, indicating that they will be treated as excluded services.

The proposed exclusion of certain activities from the price control is a direct result of the complexities of introducing an average revenue cap. Under a price cap approach, such a split in activities would be unnecessary. There would be a non-discriminatory requirement in pricing other services, no need for an overall income cap, and effectively all metering would be excluded services.

2.31-2.32 Derivation of the Revenue Driver

Ofgem lists a number of variables which it proposes to use in regression analysis to establish an appropriate revenue driver and invites views on any other potential variables.

The requirement for appropriate revenue drivers is a consequence of using an average revenue cap and could be avoided if price caps were introduced.

Under the proposal the choice of driver would be critical if DNOs were not to be put into a position of being unable to control over- or under-recovery of revenue. A driver such as number of meters would be totally unsuitable as the number of meter changes for recertification can vary by over 100% year on year. Additionally, distributors have little control over changes in meters to accommodate tariff changes, e.g. supplier-driven transfers between credit and prepayment meters. A single driver on activity, whilst simple, will leave the DNOs vulnerable to cherry-picking by suppliers. This is happening already as one supplier is actively de-appointing DNOs for simple less expensive jobs, but retaining them for more expensive ones. This is driving up the average cost of jobs undertaken.

Only a complex mix of drivers based on activities for single phase, three phase and CT meters could avoid the issues detailed above. However, given progress to date, we do not believe sufficient progress is possible to achieve a robust driver in the time remaining, and we urge Ofgem to reconsider the proposal to revert to price caps for MOP.

2.33-2.35 Basic Services

Ofgem proposes 1 June 2003 as the reference date for the functionality mix which will define a basic MOP service.

Whilst Central Networks agrees with a date of 1 June 2003 for defining the meter services offered, we are of the opinion that trying to link this to an average mix of jobs and a contract which was different in each DNO at that date, will only lead to confusion in the market. Changes in mix of jobs being requested will impact on DNOs without the ability to recover additional income.

A defined level of basic service should be agreed as the regulated service; any enhanced services should not be regulated and therefore be outside of price control.

2.36-2.35 One Way Door

Ofgem clarifies the proposal made in June - DNOs will retain an obligation to provide metering services to new suppliers, even regarding a meter point where a previous supplier had de-appointed the DNO.

Whilst Central Networks accepts the clarification and agrees with Ofgem's view regarding new suppliers, the June proposals for the one-way door only partially addressed the issue of enabling a DNO to restructure to meet a loss in market.

Ofgem proposed that a supplier could appoint a DNO at metering points, even after the same supplier had started to de-appoint the DNO at others. This will only lead to increases in the cherry-picking already being experienced in the market.

The only solution is that once a supplier starts de-appointing a DNO for any MPANs, then the DNO should be under no further obligation to accept new appointments from that supplier. The DNO would still retain the obligation to provide services to the supplier at any metering point where it was still appointed.

3. Quality of Service and Other Outputs

3.3-3.10 Interruptions Targets

Ofgem proposes updated targets for CIs and CMLs.

In our response to the June Initial Proposals we indicated that we had serious concerns with the methodology used to set the quality of supply targets, particularly the CML target. We recorded our disappointment with the lack of visibility of the process, specifically with regard to the final stages, and, despite further and repeated requests, we have still not been provided with the latest data or calculations, nor have we seen any derivation of the capex allowances associated with the CI targets. We must express again our frustration and disappointment at Ofgem's lack of transparency on these issues.

We have always stressed that quality of supply targets (and their allowances) should not be set by a mechanistic process alone and that a pragmatic approach must be taken. We have tried to engage Ofgem in exploring an understanding of the issues, particularly those associated with using the CML/CI benchmark. We consider that Ofgem's non-recognition of an appropriate glide path to its achievement misses the issues totally.

We continue to be disappointed that Ofgem does not recognise the link between network characteristics and restoration performance. From our experience we are convinced that network characteristic linkage to the CML/CI benchmark indicator is a key parameter. We acknowledge that there are CML improvements that will accrue from operational improvements, but they are generally "short-term-fixes" rather than cost-effective and sustainable ways forward.

In particular, we draw your attention to the odd position with respect to the CI targets set for CNE. Apparently small data refinements to re-establish the "start" position and changes to the benchmarks from revised data for other DNOs lower the absolute CI target by 2.3 to 76, but they also result in a near 50% reduction in the capex allowance to achieve them. In short, whilst the CNE 2010 targets have been tightened, the allowances have been significantly reduced.

We summarise our specific concerns as follows:

- Inconsistency in the target calculation. The approach requires delivery of upper quartile CML/CI performance by 2010, though the level of allowed investment in CI reduction is only based upon delivering average CI performance by 2020.
- DNO networks have markedly different characteristics. The disaggregation work shows customers interrupted per incident varies by a factor of more than 4 times across DNOs. The CML target derivation takes no account of this significant variance.
- The CML/CI benchmark within disaggregated groups also varies by a factor of 3 times across DNOs. This suggests that some companies are three times better at restoring supplies than their counterparts. This is not a realistic hypothesis.
- The DNOs have not been allowed any capex to fund improvements in CMLs. This approach is perverse as there is clear evidence that techniques such as remote control application to switching points are extremely effective capex investments that make real differences to interruption duration.

3.11-3.14 Cost Allowances

[Ofgem proposes revised allowances for CIs and CMLs.](#)

Ofgem has stated that it has taken the most cost-effective components of the FB PQ, QoS and DNO Preferred cases. Whilst we support this approach, we have not been provided with details of the derivation of CI Capex allowances, despite seeking clarification on a number of occasions.

We note that increases have been proposed to the opex allowances associated with CML delivery, and we welcome these. However, we still have fundamental issues concerning the lack of investment to underpin them. Investment in network performance improvement, as proposed in Central Networks' business plans, is essential to actually reduce the number of interruptions, rather than just rely upon more rapid supply restoration.

Ofgem's proposals mean a significant 33% reduction in expenditure on quality of supply improvements across the UK (for instance, CNE has been allowed just £1.60 per customer compared to £2.30 in DR3). We believe these reductions, coupled with Ofgem's unwillingness to allow any investment for network resilience improvements, mean that the standards of service which current and future customers expect will be compromised.

3.15 Incentive Rates

[Ofgem proposes revised allowances for CIs and CMLs. Ofgem does not propose to change the incentives rates outlined in the June Initial Proposals Paper but has updated the calculations to reflect the changes to the interruption targets.](#)

In the June Initial Proposals Paper Ofgem proposed 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.

We commented in our response to the June proposal that these had been introduced at a relatively late stage in the consultation process, without any prior introduction or discussion.

More significantly, the neutral point of the proposed QoS targets already incorporates challenging improvements in performance, and Ofgem's suggestion that a further 30% improvement can be driven by the incentive regime's rewards is unrealistic. As an example, CNE would have to achieve 47 CMLs, some 36 CMLs below the current average performance, to earn the maximum CML reward.

Our key point is that the targets represent step-changes in performance not envisaged in the design of our networks, and, because the total rewards for out-performance will not fund the fundamental network changes necessary to achieve sustainable delivery, Ofgem is effectively proposing an asymmetric incentive scheme. The consequence of this is that Central Networks will have limited incentive to improve the performance of its networks. This has clear implications for the cost of capital but, more importantly from Ofgem's perspective, effectively sends a message to customers that standards of service will not improve.

Notwithstanding our concerns above, although the implied changes are stated to be small as a consequence of the re-calculation of the interruption targets, we would welcome visibility of a modified version of the June Paper's Table 4.4., plus Tables 4 & 5 of Appendix E.

We would also welcome confirmation that the CI and CML incentive regimes are totally independent i.e. failure to meet a CI target does not preclude a reward for CML out-performance and vice versa.

3.16-3.22 Interruption Audits

[Ofgem proposes new processes for auditing measurement systems and incidents.](#)

In our previous response we stated that we support the continued application of external audits as this will ensure that consistency and RIG compliance across DNOs will continue to improve. We now note that Ofgem intends to increase the focus of the audit on the measurement systems and to split the audit of incidents into two parts in order to reduce the time taken and cost involved.

It is difficult to understand how the proposed two-part audit will achieve the desired aims of reducing the length and cost of the audit procedure in practice. Reducing the sample size in Part 1, whilst at the same time applying increased accuracy thresholds, is likely to increase the volatility of the findings, thereby ensuring that a Part 2 audit is the most likely outcome. If this is then associated with an increased focus on the measurement systems (which paradoxically often have little change between audits), it is impossible to see where time and hence cost will be saved; in fact the length of the audit could easily be increased. Furthermore, the current proposals will not streamline the preparations that DNOs need to carry out, and as a result will provide little benefit.

In the June Paper, Ofgem proposed to adjust each DNO's data to take account of any inaccuracy identified by the audit and also proposed to tighten the overall accuracy requirements from 95% to 97% over the next price control period. We argued that this would require an increased sample, which we did not believe was cost justifiable. Consequently we welcome the proposal that the current overall accuracy requirement of 95% remains.

With respect to the adjustment for inaccuracies, we support the principle of applying a correction to bring all DNOs to a nominal 100% accuracy level. However, any adjustments need 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. In the end, it is the whole population, not just the sample, which dictates whether or not the licence condition accuracy has been met.

We therefore suggest that the current audit process remains for DPCR4. Additionally, the accuracy calculations should be made part of the RIG, not hidden away in audit workbooks and subject to auditors' "interpretation". We reiterate that, in the end, accuracy is a concept that belongs to the whole population of data, not a sample, and extreme care needs to be exercised before accuracy adjustments are made.

Exceptional Events

Whilst we generally welcome Ofgem's progress in clarifying the proposed treatment of severe weather and one-off events, these proposals expose DNOs to a significant increase in risk. Exposure to this risk must be reflected in Ofgem's eventual proposal for the cost of capital.

3.25-3.39 Treatment of Severe Weather Events under the QoS Incentive Scheme and Restoration Standards

Ofgem proposes three bands of "severe weather" and describes the thresholds and how customers should be treated in each band.

We note the proposals for severe weather set out in the September update paper and also the draft Statutory Instrument which has been circulated; both build on the good work carried out by the joint DNO – Ofgem working group.

Whilst we welcome the change to the threshold for the Category 3 weather from 50% to 35% of exposed customers, we still have two serious concerns with the proposed "Very Large Severe Weather" arrangements.

- That the escalation mechanism proposed does not appropriately account for the impact of increasing scale of severe weather events, and;
- There is no upper limit to the scale of event beyond which the standards should not apply.

We are disappointed that we have not been able to explore these issues more fully in the joint Ofgem – DNO working group, but we address each in turn below.

As events become significantly larger, the relationship between size of event and repair time becomes non linear, even exponential. This is due to the limits on the number of people and equipment available (including NEWSAC resources) together with the eventual limitation on spares to effect restoration and repair. The linear relationship Ofgem proposes does not cater for this reality. For instance, our experience in the 1990 blizzards, which swept the East Midlands region, suggests that the damage a widespread severe event could create will take much longer to repair than even a "square law" approach would give.

Whilst we support Ofgem's proposal to limit compensation to 2%, with the remainder being ultimately recoverable, this raises two concerns:

- The cost of administering large volumes of payments
- The wider customer base having to make significant contributions to fund the excess payment. At an extreme, 50% of customers could be compensating the other 50%. This appears to be inequitable cross subsidisation

We do not find it credible that Ofgem would want a situation to arise where customers have to make significant contributions to fund compensation to other customers hence we strongly believe that an upper limit is essential. We, in conjunction with the rest of the industry, therefore propose a square law escalation approach for very severe weather events, with an upper limit no greater than the equivalent of 50% of exposed customers.

3.40-3.49 Treatment of Other Types of Exceptional Events

Ofgem proposes to use two absolute thresholds for other exceptional events: 25,000 customers affected and 2 million CMLs. Such events, their impacts on CIs and CMLs and DNOs' mitigating actions will be verified by audit.

Definition of the excluded event

The initial criteria specified for events to qualify for the exclusion mechanism attempts to allow only those events truly outside of the control of a DNO and some typical examples are given. However the concept of an event being "truly outside a DNO control" is multifaceted and it is extremely difficult to capture all relevant events through the use of prescribed descriptions as the following examples illustrate e.g.:

- Prevention of vandalism can be undertaken by measures such as improved security, and susceptibility to terrorism mitigated by increased vigilance, but all such actions can ever do is reduce the "reasonable probability" of any one act impacting the network. There is a cost benefit/risk evaluation that DNOs carry out in deciding whether to "contribute" to the prevention of an incident that is "outside of their control".
- The impact of fire at a substation (particularly where the cause is unknown) can often be **outside** of the control of a DNO as recent events in CNW have demonstrated. Even where fire extinguishing facilities have been fitted the impact may not be mitigated.
- Not all "third party" damage can be foreseen. For instance, during demonstrations of harpoon firing in 1998 in CNE, the Boston Harbour Master shot a line across a 132kV circuit. This circuit then had to be de-energised in order to remove the item, causing interruptions to 10,000s of customers.
- An aircraft hitting a line can be foreseen, but it is difficult to mitigate the consequences associated with such an incident.

Ofgem therefore needs to be very clear how it defines just what type of incident is deemed to be "outside of the control" of a DNO. The industry side of the QoS Working Group is looking at setting out the prescribed "one off events" through a linkage to Nafirs causal information. We support this work and look forward to proposals on behalf of all the DNOs being sent by the Energy Network Association in the near future.

Removal of the event from the incentive scheme

We consider it is unreasonable to potentially penalise DNOs under the incentive mechanism for failing targets due to incidents "outside of their control". Thus, where Ofgem chooses to define and clarify the events outside of the control of a DNO and set a threshold for qualification, then the CI and CML from these events should be **wholly excluded**. This would bring the treatment of one-off exceptional events in line with weather-related exceptional events, where the entire event is excluded.

Notwithstanding the above, the thresholds are high and beyond P2/5 designs. If the entire event was removed, this would bring it more in line with design criteria for the network. We note the intention to base the thresholds on absolute numbers e.g. 25,000 customer interruptions, albeit translated into individual DNO CI and CML values, and we welcome this approach.

Long duration events

Ofgem proposes that long-running events, such as the foot and mouth crisis, are treated in the same way as one-off events. DNOs would have to track the additional CIs and CMLs

resulting from the event for its entire duration. For every 3 month period, the CIs and CMLs attributed to the event would be measured against the thresholds, and performance in excess of the thresholds would be excluded from the incentive scheme, provided the DNO can show that it has taken all appropriate mitigating actions. In response to this proposal we offer the following views

- The collation of evidence to support an audit trail for long-running events requires definition and agreement. It would be unfair for a DNO to be penalised for collecting the wrong or insufficient evidence due to the requirements for data being undefined. This could be an appropriate area of work for the Ofgem/DNO QofS Working Group. CNE has a specific example of the difficulties in keeping both track of and estimating the impact of a Suspension of Operating Practice (No 294) for safety aspects associated with ABSDs. This “one-off event” resulted in longer restorations until remedial works could be completed and we would be happy to share the understanding this has given us of the records required of a long duration event.
- Further definition is also required for when the 3 month period is deemed to start and end and in particular what the treatment will be for events that span two reporting years.
- Again it is unreasonable that if the event is outside a DNO’s control that the entire impact should not be removed

3.50-3.54 Changes in the Exceptional Event Allowance

[After taking into account flooding, fault repairs and “1 in 20 year” events, Ofgem proposes revised exceptional event allowances.](#)

We note the revised allowances for exceptional events. We consider it prudent to increase the probability of the 1 in 20 year event in light of evidence of changing climatic conditions; current evidence suggests that these events may appear at more frequent intervals. For example, 1-10 or 1-15 year intervals may be more appropriate.

3.55-3.56 Targets for Electrical Losses

[Ofgem proposes final losses targets.](#)

We thank Ofgem for meeting our request for a worked example of the losses targets before the deadline for this response. We are now comfortable with the calculation of the targets, which we accept as stretching but sensible benchmarks.

4. Cost Assessment

Operating Costs

In Table 4.3 Ofgem compares annual allowances with company forecasts. Ofgem’s analysis is flawed due to the double-extraction of metering costs and the exclusion of items such as quality of supply improvements, atypicals, etc from the FBPQ submissions (consistent with Ofgem’s assumptions). Revised analysis shows that there is still a substantial shortfall between Central Networks’ forecast needs for operating costs and Ofgem’s proposed allowances as highlighted in the table below:

Comparison of Average DPCR4 Allowances

	CNE £m	CNW £m	Group £m
Ofgem view of FBPQs	59.8	65.6	125.4
Ofgem Sept proposal	64.0	59.5	123.5
Ofgem Gap Analysis	(4.2)	6.1	1.9
Error (metering extracted twice from FBPQ)	4.3	-	4.3
Corrected Ofgem view of FBPQs	64.1	65.6	129.7
Cost of Items not “included” in FBPQ	2.9	2.6	5.5
Updated FBPQ cost allowance	67.0	68.2	135.2
Actual GAP FBPQ v Ofgem September Proposal	3.0	8.7	11.7

4.4-4.7 Normalisation

Ofgem considers that the main issues have been addressed for this review, but recognises that annual collection of comparable cost data will be important in future.

We do not accept that normalisation has been fully addressed by Ofgem in this review. As we have demonstrated on numerous occasions, 2002/03 is an “atypically low” cost year and we maintain that insufficient adjustments have been made for this. Additionally, we believe Ofgem’s normalisation has a number of inconsistencies when looking across companies. Consequently there is bias and a lack of robustness in the analysis which may generate unsustainable cost allowances.

We support Ofgem’s determination to avoid spending six months normalising data for any particular reporting year. One of our major criticisms of the benchmarking analysis is that it has relied largely on one year’s worth of data. The use of a comparable robust panel data set would highlight these issues more clearly in the analysis. We therefore look forward to working closely with Ofgem over the coming months, and agree to put aside the necessary resources, to facilitate the introduction of cost reporting RIGs. It is our belief that benchmarking at the next review must be undertaken on the basis of panel data, rather than one particular year.

4.8-4.12 Cost Function and Composite Scale Variable

[Ofgem proposes to retain the CSV used for the June Proposals.](#)

We have argued in previous responses why we believe Ofgem's analysis has so far not captured all of the main cost drivers, citing evidence submitted by Geoff Horton amongst others. Our main concern with the composite scale variable (CSV) is:

- there has not been adequate recognition of customer density in the analysis
- HV customers are far more expensive to serve than LV customers, but this has not been weighted accordingly in the CSV

At this late stage we do not anticipate Ofgem changing the CSV, but this does not mean our concerns have gone away. There has not been a robust analysis of the drivers of costs and certainly nothing which justifies the change from that used in the last review, and the efficiency results must therefore be interpreted with extreme care. Relying almost exclusively on regressions for forming an efficiency judgement is not a demonstration of interpreting the results with care.

4.13-4.19 Regional Factors

[Ofgem indicates that this issue is still under consideration, but that it may allow more to EDF-SPN for wage costs.](#)

Most companies are likely to point to area-specific factors, which may be difficult to quantify objectively, particularly in a simplistic regression analysis.

We have provided evidence showing that an HV customer is far more expensive to serve than a typical LV customer. Central Networks has a high proportion of HV customers relative to the rest of the industry, a result of the intensity of the manufacturing industry in the Midlands. This, like other companies' concerns, is not recognised by the chosen cost driver computation, and is further evidence of the frailty of Ofgem's simplistic regression analysis.

4.20-4.21 Establishing a Benchmark

[Ofgem maintains that the upper quartile approach proposed in June is sufficiently robust.](#)

The upper quartile benchmark is equivalent to a 50% level of confidence for the basic 14-DNO regression. This low level of confidence falls even further to 25% under the 9-group regression. Setting future allowances on the basis of an upper quartile approach, whilst strong on incentive properties as it is not based on any one DNO's costs, is nevertheless too uncertain for making a judgement of future allowances. We maintain our opposition to this approach and believe that higher degrees of confidence are required as the basis for setting allowances. From the outset, we have argued that average costs should be used as the benchmark; this is consistent with how the cost of capital is set and the expectations of industry costs shifting over time.

If Ofgem continues with an upper quartile approach for regression, issues concerning the robustness of the results will remain. In our view, the problem would to some extent be mitigated if Data Envelopment Analysis (DEA) was used directly as a sense check to the upper quartile benchmark. We expand on our proposal in section 4.32 – 4.33 below.

4.22-4.24 Glidepath

[Ofgem maintains its June position of not proposing a general glidepath.](#)

If Ofgem provided an adequate sense-check of the regression analysis using DEA, we would support the policy of not using a general glidepath to the benchmark level of costs. However, if Ofgem continues to ignore such evidence, then we believe a glidepath is one way of insuring companies against the sizeable risk of Ofgem getting the benchmarking wrong.

4.25-4.26 Frontier Shift

[Ofgem revises its opex productivity assumption from 2% pa to 1.5% pa.](#)

Ofgem has argued that the available evidence supports the current 1.5% p.a. forecast for future operating cost productivity. We continue to believe strongly that this assumption, which amounts to average industry costs falling in excess of 10% by March 2005, significantly overstates the potential for future efficiencies, and we support the letter sent by the ENA on this specific issue.

We are particularly concerned about two aspects of Ofgem's use of the CEPA analysis. The first is that the top-end range of 5% used by CEPA in estimating DNOs' ongoing opex efficiencies is based on misleading historical data. Performance over the last decade has been affected by two major events; privatisation, and the move away from rate of return to incentive based regulation. These have resulted in significant inefficiencies being driven out of the industry, the scale of which is unsustainable going forward. The long term trend in other countries, such as the USA and Norway, is aligned more with the productivity trends of their general economies. Furthermore, the latest set of normalised data in 2003/04 demonstrates that costs, far from continuing to fall, are actually rising across the industry. We propose that a more appropriate assumption would be to base future expectations on forward-looking evidence and the trend rate of other countries' distribution productivity improvements. Taking all of this into account, a sustainable level of opex productivity (before taking account of the UK economy) is 2.0%.

The second area of concern is that Ofgem has not taken on board CEPA's view that operating efficiency is likely to be the result of a "combination of catch up and frontier shift". We propose that Ofgem revises its forecast by splitting the partial factor productivity assumption into a pragmatic 50:50 split between these two components, especially since an upper quartile rather than average cost approach has been used to assess efficiency. To do otherwise is to double-count the catch-up component of productivity to the frontier.

We conclude that a more sustainable view is to assume a 0.5% annual efficiency improvement. This is equivalent to average costs falling by 2.4% per annum from April 2003, and remains a challenging target for the industry to realise. This avoids the perversity of benefits being passed to customers before they have even been achieved. It also mitigates the risk of error in Ofgem's benchmarking analysis, the initial basis for setting the efficient level of costs, and the risk that DNOs may resort to unsustainable cost cutting measures simply to earn the cost of capital. We believe our proposal strikes an appropriate balance between the interests of customers and shareholders.

4.27-4.31 Total Cost Analysis

Ofgem retains the approach to total cost analysis used in the Initial Proposals and presents an update of the analysis.

We broadly support the acknowledgement that efficiency analysis cannot be based on operating costs alone. However, as we have said in previous responses, the total cash cost approach, adopted by Ofgem has a number of weaknesses compared with the capital stock approach that was recommended by Frontier Economics (March 2003). The next review must endeavour to implement Frontier Economics' recommendation and develop a capital stock measure of total cost.

Notwithstanding this, we welcome the principle that total cost should be used in assessing efficiency, and hence lend qualified support to the use of a cash-cost approach for this review. However, we strongly believe logic demands that, as well as using a 9-group regression for operating costs, there also needs to a similar total cost regression, to reflect the fact that there are not 14 independent management teams in 2002/03.

4.32-4.33 Data Envelopment Analysis

Ofgem claims DEA produces implausible results, but presents alternative analysis, using fixed weights, which it says it has not used directly.

One way to establish the credibility of the benchmark from regression analysis is to employ a second benchmarking technique as a sense-check. Until the September update paper Ofgem had been saying that it would indeed use DEA for this purpose. We are therefore extremely disappointed that Ofgem has asserted that the DEA results are implausible, without giving an adequate explanation for this judgement. It is our view that no single result from regression or DEA is without problems, especially when such a small data set is used. But we strongly reject the argument that DEA produces results any more implausible than those of regression. The frontier is driven by more than one company, which commentators have argued is a problem with using a COLS approach in regression. Furthermore, Ofgem is imposing a linear regression on the analysis, when in fact the benchmark may exhibit non-linear properties. There is therefore uncertainty with all of these approaches, and so to ignore one approach over another simply increases the risk of getting the wrong answer.

Professor Weyman-Jones, a recognised expert on this subject, demonstrated in the paper submitted to Ofgem in August that the industry is characterised by varying returns to scale. This must therefore be the basis for conducting DEA at this review. Table 1. shows the results of repeated DEA (assuming varying returns to scale), but after removing one of the nine groups at a time from the opex data set. It demonstrates the stability of Central Networks' efficiency, showing the efficiency score for CNW is 94% and 100% if Central Networks East is omitted from the analysis. It also confirms that CNE is efficient. This demonstrates that the efficiency scores from DEA are stable and must not be ignored by Ofgem in making a judgement on relative performance.

Group removed from analysis	CNW %	CNE %
EdF	94	100
S+S	94	100
CE	94	100
UU	94	100
SPN	94	100
CNE	100	n/a

Table 1 - Sensitivity analysis in DEA

One way of addressing concerns over the reliability of the efficiency analysis is to apply confidence intervals to regression and stochastic properties to DEA. Although Ofgem has not commented explicitly on these options, we would strongly recommend that such techniques are carried out as a further sense-check of performance.

As a minimum, though, we urge Ofgem to make its efficiency judgement on the industry according to a combination of the regression and DEA results. This will not increase the burden on Ofgem as we are aware that such analysis has already been produced.

At the last review, Ofgem accepted that it would not rely exclusively on regression. Inefficiency scores were derived by choosing the “lesser reduction from the PKF revised report and the regression analysis” (Dec 1999, p.21). We strongly believe that a similar mechanistic approach should be used for this review, and we propose that efficiency for each DNO is the higher of the regression and DEA scores. This will still produce a conservative view of performance because DEA ascribes all variation from the frontier as inefficiency, whereas Ofgem has partly recognised this issue in regression by choosing the upper quartile rather than COLS technique. However, if stochastic DEA is used, then it may be more appropriate to use the average of the two approaches, and we would be supportive of such an approach.

The results of a 9-group regression and DEA analysis for operating and total costs are illustrated in figures 1. and 2.

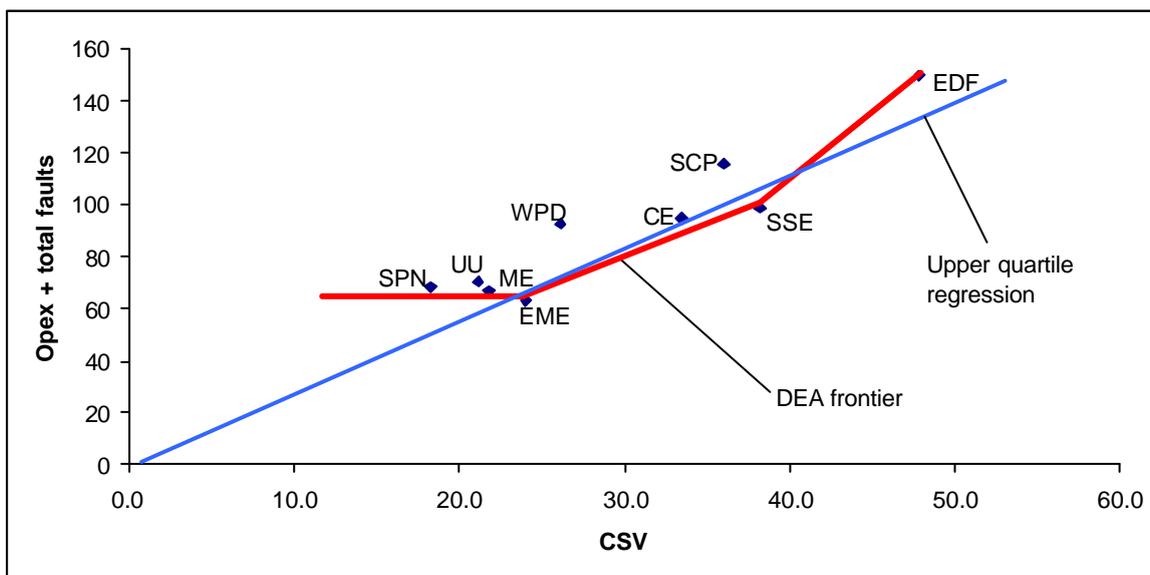


Figure 1 - DEA and regression analysis of opex plus total faults for 9 groups

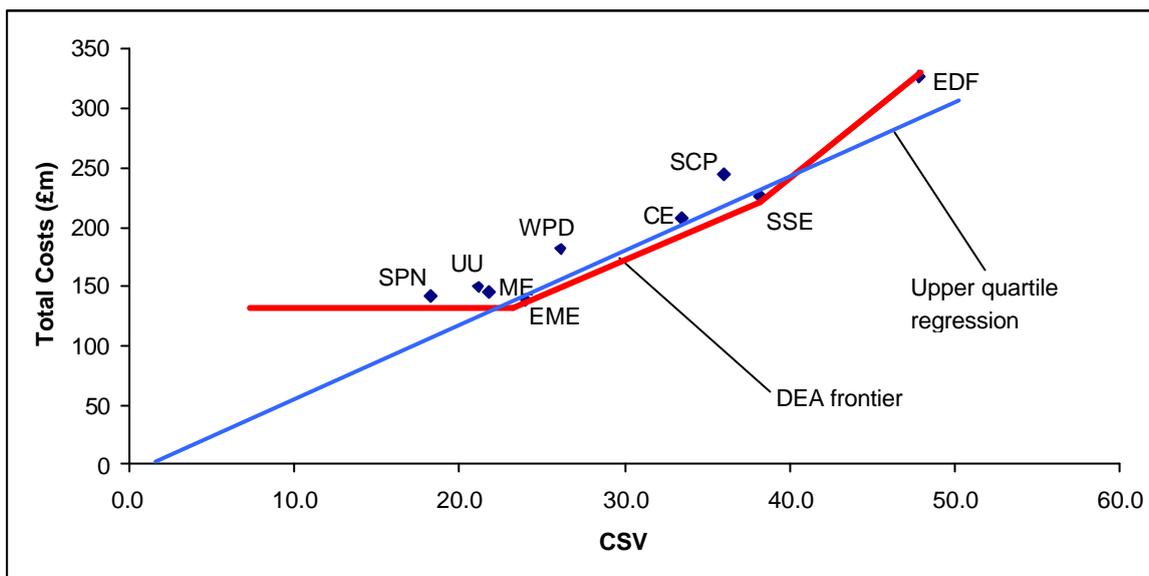


Figure 2 - DEA and regression analysis of total costs for 9 groups

We infer the following efficiencies for Central Networks from the analysis above, illustrated in table 2.

	9 group opex		9 group total costs	
	Upper quartile regression	DEA frontier	Upper quartile regression	DEA frontier
CNW	88%	94%	88%	96%
CNE	103%	100%	102%	100%

Table 2 – Sense-check of regression

Using the mechanistic approach we advocate above, and so taking the higher of (i) opex and (ii) average of opex and total costs:

- CNW is 95% efficient
- CNE is 103% efficient

4.34-4.37 Vegetation, Exceptional Events and Quality Improvement

Tree Cutting

[Ofgem proposes increases in allowances for tree-cutting.](#)

We are concerned that Ofgem’s proposed finding for tree clearance activity in Central Networks in the DR4 period is insufficient to deliver the essential safety and performance needs.

The ESQC Regulations have strengthened existing requirements for maintaining clearance between LV overhead lines and trees, the DTI guidance notes citing the example of a child climbing a tree as a source of danger to be mitigated. Consequently, it was anticipated that

this strengthening of the obligation to cut trees near LV lines would result in increased expenditure during DPCR4 and this was reflected in the FBPQ submissions of Central Networks.

CNE noted that the funding requirement for tree cutting would need to increase to ensure ESQCR compliance against a background of accelerated tree growth caused by changing weather patterns in recent years, and the CNE submission included a modest increase from £18.2m to £23.1m for the five year period.

Similarly, CNW's FBPQ submission recognised that additional funding was required for tree cutting, citing two reasons for an increase; an increased frequency of cut for 11kV lines, and a move to a more structured approach to tree cutting in the vicinity of LV lines. The CNW FBPQ submission identified an ongoing increase in annual expenditure of £1.4m above that in 2002/3. This resulted in a total submission for tree cutting for the DPCR4 period of £33m. This increase was not specifically attached to the ESQCR requirement but rather was included as a requirement for increased opex expenditure.

Ofgem acknowledged that DNOs were forecasting increased tree cutting costs and used both regression analysis and modelling to arrive at vegetation management allowances of £4.1m pa for CNE and £4.6m pa for CNW. However, Ofgem's process for establishing the allowance for tree cutting effectively only allowed a level of expenditure below that actually incurred in 2002/3, and took no account of the increasing requirement as a result of ESQCR. The value of Ofgem's proposed allowances is £10m less than the base case submission and is below the 2002/3 level of expenditure for CNW, and £2.5m less than requested in the CNE submission. By disallowing this expenditure Ofgem is effectively exposing Central Networks to an increased risk of non-compliance with the ESQC Regulations and the general public to increased safety risks.

The current implementation plans for the ESQC Regulations impose a requirement to patrol all LV lines in advance of 2008 and to rectify any urgent defects found. Although only limited information has been obtained so far, it is clear that the scale of the tree cutting work required to comply with the strengthened obligation imposed by the ESQC Regulations is actually significantly greater than that identified within the FBPQ submission. Current plans for tree clearance in 2005 across the two licences totals over £16m.

It is imperative therefore that additional funding for this activity is included within the DPCR4 allowance to ensure that compliance with the ESQC Regulations is correctly funded with an additional allocation of £7m for CNE and £10m for CNW.

4.38-4.41 Comparison with 2003/04 Analysis

[Ofgem does not propose to change allowances to reflect 2003/04 data.](#)

Ofgem should use the latest data available to inform its judgements about future allowances. We have argued above that they have not been adequately reflected in the ongoing opex efficiency assumptions made. If Ofgem continues to largely ignore this data for setting future productivity assumptions, then the data should instead be used for setting the upper quartile level of costs to be attained by all DNOs by March 2005. This is also consistent with making sure that incremental efficiencies are only retained for a rolling five years, a policy commitment made by Ofgem (Initial Conclusions, Developing Monopoly Price

Controls June 2003). Ofgem’s current approach has so far failed to correctly implement this policy.

Using a 9-group analysis of operating costs for illustration, we have undertaken regression and DEA analysis for 2003/04. The results are shown in figure 3., supporting our view that allowances should be increased for Central Networks.

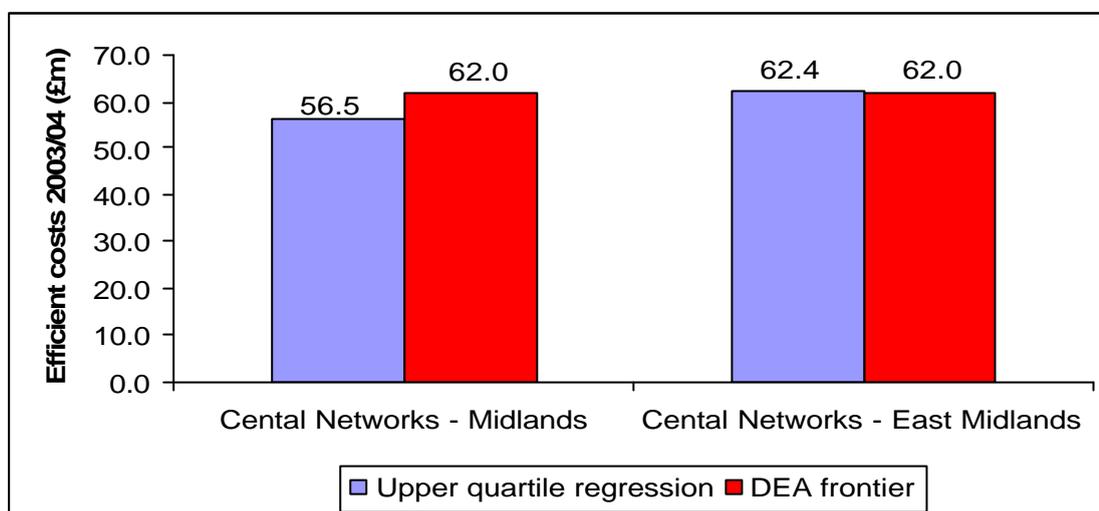


Figure 3 - Comparison of benchmarking techniques for deriving efficient costs 2003/04

Using the 2003/04 data still means that retrospective action would need to be taken at the next review for 2004/05 performance, since incremental savings would otherwise be retained for 6 years.

4.45-4.49 Mergers

[Ofgem questions whether non-merged DNOs will take longer to achieve efficient cost levels and invites views.](#)

This continues to be a key issue for us. Central Networks has consistently challenged the efficient cost levels set by Ofgem on the grounds that the benchmarking methodology used to inform the judgement on efficiency has been discriminatory and unfair to singletons. We remain disappointed that the current methodology continues to ignore many of the positive proposals that we have made to ensure a level playing field, irrespective of corporate structure. In particular we still believe that the best way of addressing this issue is to provide an additional allowance for single companies.

However we note that Ofgem has a preference for doing comparisons on a “per ownership group” basis, or setting the benchmark for “singletons” at a point already being achieved by at least one singleton.

We have advocated the first approach, on the grounds that a 14-DNO analysis is discriminatory and so must not be the basis of assessing efficiency in any shape or form. However, we maintain that a 9-group analysis should be applied, not only to operating costs, as Ofgem has currently undertaken, but also to total costs.

In addition, as we have argued in section 4.32 – 4.33, DEA analysis should be used as a sense check for regression, with the higher of the two benchmarking techniques being used

to inform the view of efficiency for both sets of costs. A singleton efficiency score can then be derived as the higher of (i) opex benchmarking and (ii) average of opex and total cost benchmarking. This proposal would satisfy our concerns, which we currently have about discriminatory behaviour over this issue.

We also see some merit in progressing Ofgem's second approach of comparing single DNOs separately. Whilst we have no problem in principle in comparing the performance of the four singletons, we do not accept that the benchmark should be based exclusively upon the frontier singleton.

Despite our criticisms of the upper quartile as the basis for setting the yardstick, we fully support the strong incentive properties, which were noted by Frontier Economics' (March 2003), of ensuring allowances are not based on any one company's costs.

We believe that, if Ofgem is to pursue an analysis of singletons, it should follow the same basic principle used in the analysis for merged entities. Using CNE's cost base (frontier singleton) as the benchmark for non-merged DNOs is at odds with this. We propose that Ofgem uses an upper quartile of the four singletons, which, for this methodology, lies midway between the first and second singletons, which are CNE and CNW respectively.

Ofgem also invites views on how future mergers, which involve a loss of comparators, should be treated, asking specifically whether:

- The policy could be implemented through the price control formula;
- The value per comparator should be converted from a fixed £m to a percentage of RAV or revenue.

We continue to have problems with the philosophy behind the merger tax and its practical calculation. Correctly addressing this issue requires a wider consultation on the principles, rather than a narrow discussion of the methodology for implementation.

4.50 Rates

Ofgem proposes that rates will be treated as a pass-through item.

We welcome Ofgem's decision to treat rates as a pass-through item.

Capital Expenditure

4.53-4.56 Base Case Capex

[Ofgem proposes increases in DNOs' base case allowances.](#)

Central Networks continues to be disappointed that Ofgem ignores the preferred cases of both CNE and CNW. These proposals include investments that make improvements to network resilience in rural areas, rather than simply sustaining existing infrastructure, and provide amenity and environmental benefits that customers do value.

Central Networks is particularly concerned that a number of important network investments contained in our submissions are not included in the September Proposals. These items have been carefully assessed to meet the needs of the network and align with the base case definitions.

We still await the revised output of the CNE modelling, but, following re-statement of ESQC expenditure, a shortfall of £60.4m remained for non-load related investment. A particularly important element of this shortfall is the need to fund the increase in wayleave termination activity, which will otherwise divert expenditure from asset replacement work.

The bad related expenditure proposed for CNE is £33.3m below the submission due to apparent uncertainty of timing, which is inevitable in a plan for seven years hence, and an invalid assertion by Ofgem that electrically overstressed switchgear does not require replacement, despite detailed representations to the contrary. The £5m reduction in the costs for replacing overstressed switchgear is of particular importance, and must be restored to the currently stated allowance.

For CNW the excluded non-load related programmes are LV overhead line replacement, Consac cable replacement and the adequate funding of wayleave terminations. Given that the implied asset life of the LV overhead line is over 200 years, this item is the highest priority of those currently excluded, and £14m for this work should be restored to the allowance.

In addition, despite our spending substantially more than the reduced DPCR3 allowance in the current review period, CNW's bad related allowance is also £17m lower than planned. Ofgem's proposed reduction severely compromises our plans to reduce the number of networks at risk to P2/5, and the £17m should be reinstated.

Central Networks East

The proposed increase still does not meet our base case requirements and ignores the CNE preferred scenario. The base case total allowance of £476m is compared with an adjusted forecast of £480m, but, we cannot reconcile these numbers with our submission. Our estimate of the adjusted base case forecast is £522m and therefore, excluding the sliding scale allowance, we still see a shortfall in the allowance of £87m.

Load Related

It is proposed that CNE is allowed a gross demand related expenditure of £364.0m during the DPCR4 period compared with the base case submission of £397.3m. This represents a shortfall of £33.3m compared to the submission, with no explanation of how this reduction is calculated, and a reduction of £7.0m from the June proposals.

The reductions proposed by PB Power and Ofgem in the June Paper appear to have been carried forward into the September Paper and are not acceptable as follows:-

Reinforcement Schemes

The majority of reinforcement portion of the load related submission contains named projects at 132kV & 33kV for the 5 years of the review period and a small sum, based on existing expenditure levels, to deal with in-programme developments, mainly voltage complaints and quality of supply issues at 11kV and LV. Reference is made in the report to the potential “shift in timing of one year at the end of the programme that could reduce expenditure by £15m.” There will be uncertainty in any programme which aims to predict the exact situation in 5/6 years time, and all competent asset managers require flexibility to reprioritise work within a budget during a 5 year period. Since this expenditure is driven by events on the network caused by customers connecting equipment, and as there are no contingency sums built in to the CNE submission, it is inevitable that some re-phasing will be required. This does not imply an intention to under-spend the allowance, simply, a re-prioritisation for which there should be no penalty, either by reduction in the allowance or by a lower return captured in the sliding scale mechanism. Indeed, during PB Power’s on-site investigations, an additional £12.5m of justifiable EHV load related projects were demonstrated that had not been included in the submission. Ofgem’s proposed reduction is not justified and will increase the level of risk, especially with regard to our obligations to maintain supplies within the limits of P2/5.

Earth Loop Impedance Schemes

Reduction of the Earth Loop Impedance expenditure of £10m, identified in PB Power’s June Report, will result in CN East carrying a level of risk higher than we believe to be acceptable. Under current legislation, having identified a potential Health and Safety risk, mitigating action needs to be taken. Reducing available funds will ‘stretch’ resolution of this issue beyond a reasonable time horizon.

Overstressed Switchgear

The overstressed switchgear change programme is based on the revised fault levels supplied by National Grid. CNE 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 to be changed during the DPRC4 period are currently beyond 100% of their rating.

The total programme for overstressed switchgear amounts to £26.4m (Split is £15m 132kV, £5.9m 33kV and £5.5m 11kV). Even if switchgear that is calculated to be between 95% and 100% is removed from the proposed programme, only savings of £835k could be made, compared with £5m in the report. We consider that any reductions in proposed expenditure increase risk beyond acceptable limits and therefore no reduction should take place.

Failure to allow this expenditure will inevitably result in unacceptable pressure on the non-load related budget as a significant number of the sites will require switchgear changes due to condition during the DPRC4 period. Finance was not included in the non-load related submission of CNE for this activity.

Non-load Related

Following the restatement of of CNE's base case to address the issues regarding categorisation of expenditure between asset replacement and ESQCR expenditure, Ofgem proposes that CNE is allowed a non-load related expenditure for asset replacement of £269.0m during the DPCR4 period, compared with the base case submission of £329.4m, a shortfall of £60.4m.

Key reductions appear to be wayleave terminations and asset replacement due to PB Power modelling.

Wayleave Terminations

Ofgem has proposed a reduced base case allowance for wayleave terminations. This is based upon the forecast total DPCR3 expenditure and PB Power's interpretation of the base case guidelines, which are that the 'existing rate of wayleave terminations is maintained'. However, the number of termination notices and expenditure has been increasing steadily during DPCR3, and the average historic value therefore significantly understates the current level of activity. It is therefore more appropriate to use current levels of activity, rather than historic averages in establishing the 'existing rate'; this was reflected in CNE's 'preferred scenario' submission. We also do not accept the application of industry averages to a specific problem, where local agents systematically challenge the continued presence of our assets.

The shortfall between the proposed allowance and the Central Networks East preferred scenario of £15.4m should be added to the allowance.

PB Power Modelling

Having identified a number of errors PB Power's June report, upon which Ofgem's opinion was formed, and agreed these errors with PB Power, CNE awaits confirmation of the revised model output and the details contained therein.

Notwithstanding the above, CNE has reservations on the application of the model as its output does not appear to make any allowance for practical considerations. This is typified by the costs used for NLRE Overhead Line and Cable replacement in the model. Whilst a weighted average is claimed, the costs do not appear to allow for the proportion of undergrounding that is essential due to urbanisation encroaching on existing overhead lines. There is a systematic and inherent downward bias in PB Power's modelling, which effectively uses the lower of company bid or PB Power threshold. Application of a post-event sliding scale is not a suitable compensation for this.

PB Power acknowledged that there is considerable backlog in asset replacement within CNE due to the low levels of allowances in previous review periods. This has not been adequately identified in their modelling, and therefore is not sufficiently reflected in Ofgem's proposed allowances.

Central Networks West

For CNW, the change from Ofgem's Initial Proposals to the September Update is insignificant. The concerns expressed in our response to the initial proposals therefore remain.

Load Related

A number of network load related reinforcement schemes were proposed aimed at maintaining the operational integrity of the network and compliance with licence conditions. These were 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 continued operation at such a level is not desirable.

PB Power proposed a cut in the base case capex allowance, equivalent to the schemes that will reduce security risk, on the basis of its interpretation of base case assumptions, which state that a reduction in risk can be interpreted as an improvement in performance. PB Power does not dismiss the validity of the schemes and the base case allowance should be increased by £17m to allow funding of these schemes.

Non Load Related

Within the non load related allowance, a number of proposals were disallowed or reduced; LV overhead line replacement, Consac cable replacement and wayleave termination expenditure.

LV Overhead Line Replacement

PB Power has proposed that the allowance be reduced because the increased activity identified for replacement of LV overhead lines is not supported by evidence of increasing fault rates, as no mention of the issue is included in the Ofgem 2002/3 Electricity Distribution Quality of Service Report. However, the information in the Quality of Service Report is very limited in scope and is not the means by which such issues are identified.

CNW submitted information to Ofgem in the 2003/4 Medium Term Performance report showing an increasing trend in condition-related faults on LV overhead line, and so demonstrating a deteriorating asset. PB Power's assumption is therefore incorrect.

As PB Power acknowledges, this increasing fault rate is supported by an increasing volume of condition reports indicating that the assets are at the end of their useful life. PB Power confirms that the volumes proposed for this activity align with the output of its model, and that the life assigned to this asset by CNW is significantly longer than the industry generally. PB Power's report also states that "from an asset management perspective the decision to commence an increased replacement programme may now be considered prudent practice".

CNW accepts that, in the recent past, overhead line activity has been focussed on the 11kV network where quality of supply benefits are the greatest. However, the evidence is clear that, unless replacement of the LV overhead network is increased, the base case requirement to maintain fault rates at their current levels will not be achieved and it is therefore imperative that Ofgem reinstates the £14m investment identified, which would still only deliver a 200-year replacement cycle.

Consac Cable Replacement

PB Power has proposed a reduction in the Consac cable replacement allowance to align intended expenditure with 'industry levels'; this is wholly inappropriate. CNW has a programme of Consac cable replacement that is initiated at locations where successive fault repairs, joint replacement and replacement of faulty cable sections do not deliver acceptable

service. In these situations, where the same section of Consac cable faults repeatedly and causes unacceptable service levels and safety issues for customers due to the loss of neutral / earth connections, the cable circuit is clearly at the end of its useful life.

The replacement programme is undertaken on a 'worst first' basis, and CNW is experiencing an increasing trend in the requirement to replace Consac cable that shows no sign of levelling out. Restricting the allowance for replacement will lead to an increase in faults on these networks, and so an inability to comply with the base case requirement to maintain fault rates at their current levels, with consequent impacts on customer interruptions and safety,

The planned expenditure of £33m for DPCR4 is not excessive and equates to a replacement life of 102 years.

Wayleave Terminations

Ofgem has proposed a reduced base case allowance for wayleave terminations of £18m. In addition, the CNW alternative scenario identified an additional requirement of £7m for the DPCR4 period in recognition of the increasing volume of this, externally driven, obligation. The arguments put forward for CNE apply equally to CNW, and, therefore, the allowance should be increased from £18m to £29m to avoid delaying the essential asset replacement activity of this obligatory work.

4.57-4.59 Resilience and Worst-served Customers

[Ofgem does not believe there is sufficient customer benefit to justify specific allowances, but points out that the sliding scale mechanism gives DNOs headroom for such expenditure.](#)

Both CNE and CNW submitted proposals that would increase the resilience of overhead networks and improve supplies to worst served customers. We are disappointed that Ofgem has failed to take the opportunity to fund these activities, which make real improvements to the resilience of local electricity networks. Both the Trade and Industry Select Committee and Ofgem's own willingness to pay survey provide support for this kind of investment.

We continue to believe that disallowing expenditure on resilience and sensible environmental amenity spend is not in the long-term interests of our customers and the UK economy.

Ofgem has rejected the submissions on the basis that they appear poor value for money and would require subsidisation by other customers. It is, therefore, unhelpful of Ofgem to suggest that the sliding scale mechanism could provide funding for these activities, since this mechanism would not improve value for money or avoid cross subsidisation.

4.60 ESQCR

[Ofgem proposes to consider ESQCR costs in 2008 when site surveys are completed.](#)

DNOs were required to identify, within base case submissions, those costs that would be incurred in complying with the ESQC Regulations. Having examined the submissions, Ofgem concluded that more work needed to be undertaken to understand the level of efficient cost levels for this work and decided that all ESQCR costs would be excluded from the allowances until more accurate information is available from the surveys that are

required to be undertaken by 2008. Ofgem acknowledged, however, that the surveys would identify situations that would require immediate action to prevent danger.

Evidence from the surveys undertaken so far suggests that this work will entail a significant expenditure of both opex and capex. We covered the opex requirement in section 4.37. Here we focus on the capex requirement.

The total estimated capex requirement for ESQCR compliance is £28m for CNE and £19m for CNWt. Although Ofgem has committed to allowing DNOs to recover efficient costs, no allowance has currently been made for this work.

The majority of the work is anticipated to be associated with overhead line proximity and is therefore a 'safety' issue. It is also likely that a significant proportion of this will be deemed to be urgent and will need to be carried out before the review of the total costs is carried out in 2008. CNE's estimate of the cost of this urgent work is £7m and, if only 25% of the likely work in CNW is deemed to be urgent, this amounts to £5m.

There will be significant costs for both CNE and CNW in complying with the ESQC Regulations *before* the Ofgem review in 2008. It is vital therefore, that Ofgem provides additional allowances in both opex and capex for the intervening period to allow full compliance without increasing risk on other parts of the network.

4.61-4.62 Fluid Filled Cables

[Ofgem says this issue is unlikely to be resolved before November and will be addressed separately after the Final Proposals.](#)

Central Networks supports Ofgem's interest in the replacement requirements for fluid filled cables. Whilst the DPCR4 submissions include projects that remove some aged cables with high leakage rates, the low level of overall replacement is of concern given the importance of the circuits that use fluid filled cables and the environmental impact of continuing oil loss, particularly in Birmingham and the West Midlands conurbation,.

4.63-4.66 Sliding Scale Mechanism

[Ofgem compares DNO base case forecasts with PB Power's view of allowances.](#)

Table 4.6 compares the 'base allowances' with the requested amounts. CN East cannot reconcile the adjusted company forecast and so cannot agree with the assessment in the September Update

The sliding scale mechanism is fundamentally dependent on the accuracy of PB Power's modelling. However, there is a systematic and inherent downward bias in PB Power's modelling, which effectively uses the lower of company bid or PB Power threshold. We believe we have submitted accurate forecasts of the required capital expenditure and so Ofgem should allow the 40% marginal incentive rate.

We continue to have concerns regarding how sliding scale allowances are derived (they have changed since the Initial Proposals, but it is not obvious how) and how the mechanism will work in practice.

4.67-4.76 Incentives

[Ofgem proposes updated incentive rates for capex and is considering 3 ways of equalising the incentives on opex and capex.](#)

This is a key issue for Central Networks.

The proposal to equalise opex and capex incentives, first mooted in March 2004 and developed into a detailed proposal in May 2004, materially weakens the opex incentive and will have major implications for behaviour. It will lead to much lower efficiency savings, higher costs and higher prices: this cannot be in the interests of current or future customers. It could also result in more short-term-focussed opex-based solutions and produce a need for the regulator to monitor companies' actions in detail. Ofwat, whose regime expenses both opex and replacement capex because of the definition problem, inspects asset management plans and outcomes. The promise to restore incentives at some point in the future, after a consistent cost framework has been established, also perversely introduces "gaming" as companies potentially store up savings for the future.

Ofgem's proposals represent a disproportionate reaction to the issue that it is trying to resolve, of attaining consistency in cost reporting, and will radically alter the substance of the price control. These proposals strike at the heart of incentive regulation and RPI-X and represent a substantial move towards rate of return regulation. To make such a fundamental change at this late stage in the process has particularly profound implications for Central Networks as it makes significant investment in a change process to remove duplication and drive through best practice. This investment is entirely compromised by the current proposals, and is inconsistent with our legitimate expectations in relation to the treatment of efficiency savings, based on Ofgem's initial conclusions on developing monopoly price controls (June 2003). For the avoidance of doubt, Central Networks cannot accept any weakening of the opex incentive and we support the letter sent by the ENA on this issue on 30th September 2004.

We continue to strongly support Ofgem's intention to establish a consistent cost reporting framework, which will significantly improve benchmarking at DPCR5. Central Networks will commit the necessary resources to facilitate putting the RIGs in place by 31 March

2006. However we fundamentally oppose the proposal that this be directly linked to a significant weakening of opex incentives until Ofgem is satisfied that consistent reporting has been achieved. Instead we propose:

- Central Networks will discuss with you the detailed rules and processes used for 2002/3 data as adjusted by your normalisation and specified DPCR4 adjustments and commits to continue to apply those rules and processes across the period of the price control.
- Central Networks' continued application of those rules (i.e., its commitment) would be subjected to formal external annual audit each year; and
- Central Networks will work proactively with you, within a "reasonable endeavours" framework, to agree a framework with all DNOs for comparing costs in future.

5. Financial Issues

5.3-5.5 Base Revenues

[Ofgem presents revised 2004/05 forecasts and impacts on P0.](#)

We are working with Ofgem to understand the basis of our 2004/05 revenues used in the update document to calculate the P0 impact. From discussions to date it appears that Ofgem has added back the merger tax twice to allowed revenues.

Generally we are concerned that the current approach does not aid comparability between companies and between price reviews. The inclusion of a number of revenues in 2004/05 outside of the 'base' revenues appears to exaggerate or suppress the P0 adjustment, depending upon the nature of those revenue adjustments e.g. under / over recovery, losses incentives and penalties, DMSCR etc.

These inclusions are captured in the 'other' section of the P0 analysis (provided in the Price Control Calculations tables) and their effect on individual DNO's P0 adjustments ranges from -15.3% to +1.6%. This is a huge range which makes P0 comparisons meaningless. In the absence of a comparable P0 methodology, it would at the very least be desirable for Ofgem to list the significant elements, and their effects on the P0, of the 'other' section in the Price Control Calculations tables.

Pensions

5.10-5.11 Allocation to Distribution

[With the exceptions of EDF-EPN, CE-YEDL, SSE Hydro and SP Distribution, Ofgem proposes to apply the pragmatic assumption that 80% of deficit will be allocated to distribution.](#)

Central Networks supports Ofgem's pragmatic approach.

5.12-5.18 Treatment of ERDCs

[Ofgem proposes to disallow 30% of ERDCs.](#)

Ofgem has disallowed 30% of ERDCs on the basis that DNOs have already received the benefit of the first five years of opex savings.

There is no logic to the proposal to reduce ERDC-related deficits for investment returns, as there is no suggestion that DNOs should have put additional cash into the funds (thereby enlarging the surpluses at the time even more). The use of surpluses for ERDCs has been accepted by Ofgem as an efficient action. If this had not been accepted and additional cash was expected to have been put into the schemes, then the value of any additional contributions would have fallen over the period, along with the rest of the pension fund, and an adjustment for investment cost (rather than income) would therefore be expected.

Ofgem's adjustment for historic returns increases the amount of disallowed deficit by £6.3m and changes the 70:30 split quoted to a 67:33 split for CNW and a 59:41 split for CNE.

We believe that an 82/18 split is more appropriate, but, at the very least, a 70/30 split should mean exactly that, with no adjustment for historic returns. In practice, given stock market falls, any adjustment would act in the opposite direction.

2004/05 Contributions

Ofgem states that it is “disallowing 1/13 of the [pension] deficit to account for contributions made in 2004/5”. There is no justification for this because, in accordance with the 2004 valuation timetable, all DNOs (in England and Wales) expect to start deficit correction contributions from April 2005. In addition, there is no allowance for deficit correction in the current price control (i.e. 2004/5). The issue is compounded further by spreading the remaining deficit over 13 years, rather than 12, from the start of the price control period.

It is not appropriate for Ofgem to reduce pension deficits by 1/13th for 2004/5 contributions. The valuation timetable is also consistent with action taken when funds were in surplus. This aspect of the pension calculations should be amended accordingly in the Final Proposals.

Deficit Amortisation

Ofgem has indicated that the deficit will be amortised over the remaining service life specific to each DNO. In the case of Central Networks East and West this is 13.5 and 12.2 years respectively

Cash-flow

Ofgem proposes that DNOs’ cash-flows to the pension fund will be paid over approximately 13 years, beginning in 2005. Ofgem has apportioned this 57.7:42.3 in favour of capex and hence funded a significant proportion over 33 years (13 years spreading plus 20 years RAV depreciation).

Under FRS15 (paragraphs 9 and 13), the funding of pension deficit costs must be expensed. Consequently, all of the deficit costs should be attributed to opex and funded accordingly.

5.22-5.24 Tax

Ofgem proposes

- to retain the use of companies’ 2003/03 tax computations without adjustments
- allowances based on the classifications of opex and capex used in the price control calculations.
- under- or over-performance will be calculated after adjusting actual tax to remove the effect of group relief.

When calculating the allowance for tax in the June Initial Proposal document Ofgem made a number of assumptions which were unrealistic and overly aggressive and resulted in allowances for tax being significantly understated. Following lengthy debates with the industry, Ofgem has recognised the validity of a number of our arguments and reflected this in the September Update. We welcome these changes.

The interest payable figures used in the calculation of the tax allowance remain inconsistent with the 60:40 debt:equity ratio assumed in the main price control calculation. All cash-flow shortfalls are still assumed to be funded entirely by debt.

In addition, Ofgem has not provided any details as to how the mechanism for determining over- and under-recovery will work. We are concerned that post-event disputes might arise if clarity is not established now.

Central Networks will present (prior to the GEMA meeting) a proposal and model that would be used to determine the actual deemed tax charge retrospectively. We would also wish to see Ofgem's "model". Central Networks' proposal will include data definitions, areas where adjustments are expected and a materiality threshold.

Regulatory Asset Value

5.31-5.52 Regulatory Asset Value

[Ofgem is proposing to disallow a number of costs from the RAVs of CNE and CNW.](#)

Changes to the RAV have been controversial and arbitrary, demonstrating the regulatory risk imposed by Ofgem on DNOs as a result of the lack of clear accounting rules assumed in the DPCR3 settlements. We propose to give clear and detailed accounting policies to Ofgem which we have used to produce the DPCR4 BPQs for CN, but adjusted for any "normalisation" changes effected by Ofgem or any known accounting assumptions made by Ofgem in setting allowances. This will avoid any RAV uncertainty in future and negate any need for Ofgem to reduce the incentive to make opex saving by equalising it with the capex savings incentive.

Nevertheless, given the position inherited from the last review, we believe Ofgem has made significant progress in reaching a pragmatic solution on the content of the RAV. We continue to be frustrated however by the thinking behind some of the decisions made by Ofgem, particularly in respect of control room and corporate costs and the exclusion of non-operational depreciation in respect of assets used for capital work.

Ofgem is proposing to deduct £16m of corporate and control room costs from the RAV of CNE. Such costs have always been appropriately capitalised by CNE and hence, in the absence of any adjustment to the contrary by Ofgem or PKF at DR3, were assumed to be part of the capital allowance in agreeing to DR3. To now seek to retrospectively deduct such costs from the RAV is contrary to the basis on which we accepted DR3 in March 2000.

In a similar vein, CNW has also continually capitalised an element of its control room costs (£4m) and again no adjustment was made to deduct such costs from capex in DR3. These costs reflect the additional resources required to conduct network operation to allow the undertaking of capital activities on the network and are appropriately capitalised and hence should be left in the RAV.

In addition, Ofgem is failing to take into account a key difference between CNW and other DNOs, the fact that it chose to continue ownership of commercial vans and lorries and undertake more capital work itself, rather than contract out the work to a third party. The capital cost (the proportion of non-operational capex relevant to capital activities) of using these vehicles should reside within the RAV, consistent with the treatment we believe we accepted in DR3, there being no adjustment undertaken by PKF or Ofgem to reverse this treatment. Furthermore, this treatment discriminates against a company which chooses efficiently to own its own vehicles, rather than lease them or contract out the activity. In

these cases, the costs would be validly incurred within the total cost for undertaking the capital work and hence remain in the RAV. To now retrospectively disallow £11m from the RAV of CNW seems both contrary to the agreement of DR3 and unfair in that such costs relate directly to capital work, falling naturally into capex and hence the RAV.

This argument also applies to tools where Ofgem is seeking to deduct £4m. Again, if the work was subcontracted to a third party, the cost of using the tools would be incorporated into the overall invoice price capitalised. To deduct such costs from the RAV now is therefore inconsistent with the treatment of such costs across much of the industry.

Finally, we have identified an omission from the CNE RAV calculation of £2.2m in respect of new meter installations in respect of 2000/01. These costs, whilst expensed statutorily, were subject to a PKF adjustment in DR3 to add them into capex and hence were disclosed in the BPQ as a DR3 adjustment.

Ofgem must allow costs to be left in the RAV which were included in capex when we agreed to DR3. Moreover, the treatment of vehicle and tool costs in CNW RAV roll-forward discriminates unfairly against us, compared to where such costs sit in other DNOs, and against the contract we believe we agreed at DR3.

Additionally, £2.2m of new meter installation costs must be added to the RAV of CNE in respect of 2000/01 to align with the PKF adjustment at DR3.

Financial Profiles

Based on its financial model, Ofgem proposes to set an X factor of 0. Ofgem believes this raises a financing issue for EDF-SPN only, and invites views on whether it should adjust depreciation profiles.

Ofgem notes that key financial ratios are dependent upon cost of capital and invites new evidence or analysis that it should take into account in settling on an appropriate rate.

The price control calculations used in the September Financial model have been changed to those used at DPCR3. As shown in the table below, under the latest methodology cash outflows are discounted mid-year to calculate a present value but RAV movement is discounted at the end of the period..

	2005/6	2006/7	2007/8	2008/9	2009/10	Total	
Opex / tax / other	107	103	98	92	87	487	Mid year PV
Deprn	73	69	70	72	73	356	End year PV
Return @ 5.4%	48	48	47	46	45	235	End Year PV
Capex cash out	116	110	104	99	93	522	Mid year PV
Capex add to RV	-113	-107	-101	-96	-91	-508	End year PV
Total PV	230	223	218	213	207	1091	

The figures used are for Central Networks – East

This methodology implies that:

- RAV depreciation occurs at the end of each year. Clearly, the nature of depreciation means that RAV depreciation will be incurred evenly across each year. Therefore it would be more appropriate to use mid year discounting

- return occurs at the end of the year. Again this is unlikely to be the case; any providers of debt finance will require payments to be made throughout the period, rather than at the end of each year. As for the providers of equity finance, they will also require their return during each year, especially when it is considered that the indexation of the RV forms a significant part of their return.
- Capex cash-out is a different figure to capex additions to the RAV.

Instead of using the methodology adopted in the September update, Ofgem should revert to the methodology adopted in the June initial proposals whereby mid-year discounting is applied to regulatory costs to calculate NPV. This methodology is consistent with that used in both the Transco and NGC price control reviews and that currently used by Ofwat.

	2005/6	2006/7	2007/8	2008/9	2009/10	Total
Opex / tax / other	107	103	98	92	87	487 Mid year PV
Depn	74	71	72	74	74	365 Mid year PV
Return @ 5.4%	50	50	49	48	47	245 Mid year PV
Capex cash out	116	110	104	99	93	522 Mid year PV
Capex add to RV	-116	-110	-104	-99	-93	-522 Mid year PV
Total PV	232	224	219	214	209	1098

Cost of Capital

To attract funds into the electricity distribution sector Ofgem will need to raise the proposed cost of capital. The cost of capital Ofgem has previously suggested, of 6.6% pre-tax real, 4.6% post tax, is inadequate and will lead to less investment than customers require and deserve.

In assuming (even if it is only for modelling purposes) a cost of capital of 6.6% pre-tax, Ofgem has failed to properly take into account the following:

Investment Needs

Independent studies at an industry level and our own plans show that investment levels are increasing significantly over the period and that the new-investment-to-RAV ratio is higher, at 52%, for electricity distribution than for water, at 44%.

Asymmetry of Risk in Judgements on the Cost of Capital

Whilst we accept that, if the figure is too high, shareholders will earn too much and prices to customers will be too high, we would suggest that the implications of the converse, i.e., if the figure is too low, are far more significant. There is likely to be underinvestment and an overall economic loss as well as a change in the distribution of benefits between parties. This is a particularly serious risk at the present time when such a large investment programme is needed. Admittedly, it is in our interest to say so, but it is still the case that one should err on the high side in estimates of the cost of capital. As we demonstrate with the quotes below, there are precedents for this position in UK Rail regulation (October 2000) and more recently in the New Zealand Gas Industry (May 2004).

The Rail Regulator: Periodic Review of Railtrack's Access Charges Final Conclusions October 2000

5.32 *In considering the appropriate value for the cost of capital, the Regulator has discharged his duties including the duty not to make it unduly difficult for Railtrack to finance its relevant activities. He has therefore had due regard to the scale of the investment programme which Railtrack is expected to undertake and the need to raise substantial new debt and equity finance in order to*

deliver this investment. As indicated in December 1999, he considers that these factors mean that the allowed rate of return should be set towards the top end of his estimated range for the cost of capital. His final conclusions on Railtrack's revenue requirements as part of the periodic review therefore assume a real pre-tax rate of return of 8%.

NEW ZEALAND COMMERCE COMMISSION

Gas Control Inquiry Draft Report - Public Version 21 May 2004

7.79 The Commission proposes assessing profits against all three estimates of WACC given the uncertainty associated with the parameter estimates. The Commission notes concerns about the asymmetric nature of errors in assessing WACC, i.e. underestimation is the more serious error because it may lead to underinvestment by the regulated firms. These considerations are taken into account in the Commission's judgement as to whether there are likely to be net benefits to acquirers from control. The Commission also proposes to take the 75th percentile of the WACC range (i.e., half way point between the High WACC and Mid Point of WACC) in the final report, in order to judge whether there are net benefits to acquirers.

Financeability

Ofgem wants a credit rating that is comfortably within investment grade rating yet is penalising companies with a gearing rate lower than 60%. The implied gearing rate for Central Networks rises through the period and is more likely to attract a B rating. Ofgem cannot rely on the balance sheet strength or otherwise of parent companies and needs to ensure that the licensees themselves are fundable. Ofwat has addressed this issue with an uplift for financeability and Ofgem should do likewise.

Equity Investment

Ofgem suggests that it wishes to retain equity funding, but in a competitive market place funds are more likely to flow to other sectors such as water. 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.

Increased Risks and Reduced Out-performance Opportunities

Ofgem's proposals increase the financial exposure to operational performance and storms and at the same time use a statistically flawed upper quartile cost benchmark. In addition new challenges like Distributed Generation and the need for substantially increased investment make the sector significantly more risky than previously. We do not accept Ofgem's hypothesis that allowing a portion of validly incurred ERDCs reduces risk for companies.

Market Sentiment

The feedback we have received from analysts clearly suggests that they believe Ofgem's final proposals for cost of capital should be higher than that proposed so far, in line with the proposals in the water industry. They cannot understand the rationale for any difference.

Comparisons with Other UK Regulators

Ofgem also mentioned in their analysts' presentation comparisons with regulators other than Ofwat. CAA and ORR are regulatory precedents, which have used a cost of capital above the mid-point of their ranges. There has also been a recent report by Ofcom, published 30 September 2004, which concludes that the nominal pre-tax cost of capital for BT is 13% (6% fully post tax, real). Adjusting to a 60% gearing assumption, this gives a post tax, real WACC of around 5%, assuming no increase in the equity beta from this increased gearing. Again, this is broadly supportive of the Ofwat numbers and the top end of the Ofgem range.

We and other industry parties have sent you a number of studies and views demonstrating the need for a higher cost of capital. We have had no response from you on these specific suggestions. In addition to the points raised above we fully support the ENA's cost of capital letter of 8th October.

Cost of capital should be set at 7.2% pre tax real, the top of the cost of capital range proposed in the March document.

SUMMARY OF RESPONSES TO JUNE PROPOSALS

We note that the update paper does not include any further information in respect of distributed generation (DG).

However the Summary of Responses to the June 2004 Initial Proposals (paragraph 5.5) introduces new proposals in respect of the proposed network availability incentive for DG.

In our view new proposals of this type should properly be highlighted in Proposals or Update papers, rather than being embedded in documents purporting simply to summarise others' responses.

We are concerned at the continuing lack of clarity around the proposed network availability incentive and, as a result of this, have been unable to include a clear policy in our draft Use of System Methodology Statements. It appears to us that there is the possibility of a 'double whammy' with this incentive - with DNOs paying rebates to users, **and** suffering reductions in allowed revenue. We urge Ofgem to bring some clarity to this matter.