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Dear Martin

ELECTICITY DISTRIBUTION PRICE CONTROL SEPTEMBER UPDATE

We set out below our views on four issues:

- Metering;
- treatment of overstay penalties;
- financial model; and
- cost of capital.

Although cost of capital was not considered in the September Update, responding to this document is the last formal opportunity for comments prior to final proposals.

Metering

We welcome the recognition in paragraph 2.20 that existing meters have been provided as a result of regulatory obligation and therefore that it would be inappropriate for the risk of premature replacement to be burdened solely upon the DNOs. However, we note that Ofgem intends to prohibit termination charges for these meters but will allow DNOs to reflect reduced expected meter life in their charges. This will result in suppliers who retain the DNO meter subsidising those suppliers who terminate early. Therefore the proposals would appear to incentivise suppliers to replace meters early. This does not appear cost reflective nor in the customer's interest, as it will tend to result in premature replacement of meters at increased cost to the consumer.

We note from paragraph 2.29 that Ofgem does not intend to publish the breakdown of Meter Operation activities by DNO as these are of a confidential nature. Nonetheless, in the interest of clarity, the core services common to all DNOs should be defined.

In addition we note that the definition of meter assets has not been clarified. As we have previously responded, we believe that it should include all metering equipment from the out-going terminal of the cutout up to and including the out-going terminals of the meter or time switch.

Finally, we welcome Ofgem's proposals for removal of obligations on licensees from 1 April 2007. Similar obligations with respect to gas metering were to be removed from 1 April 2004 but this was delayed by the introduction of the new gas metering arrangements. Now that this has taken place, and competition in gas metering exists, we look forward to the removal of similar obligations in respect of gas meters.

Treatment of Overstay Penalties

The document states that overstay penalties were not explicitly considered at DPCR3 and would be excluded from RAV additions. It is unrealistic to expect companies to never incur penalties as overstays may be incurred by an efficient company for a number of reasons. For example: road authorities may be unrealistically optimistic on the duration of a job; unexpected problems may be encountered such as the need to manufacture obsolete parts; third parties or inclement weather may hinder progress. Therefore, at the very least, an allowance for an efficient level of over-stay penalties should be included in regulated revenue.

Financial Model

Paragraph 5.57 re-iterates the financial ratios being used to assess whether a notionally geared company will be able to maintain a credit rating comfortably within investment grade. It is still not clear what credit rating is being targeted or the extent of the financing issues referred to in paragraph 5.58 affecting EDF-SPN and potentially other DNOs. For example, is one or more indicator being breached, and is the breach short or long term? To the extent that rising levels of investment are driving the breaches, it would seem likely that an increasing number of DNOs will be affected. Advancing depreciation profiles only offers a short-term fix which will reduce long term RAV, thus reducing companies' ability to absorb cost shocks in the long term.

Cost of Capital

In the past, we have queried why Ofwat perceive the need for a higher cost of capital for water and sewerage companies than Ofgem is proposing for electricity distribution. There is a perception that water requires a higher cost of capital in PR04 due to the scale of the capex programme being proposed and the increased financial risk that this presents to investors.

However, we note from the aggregated financial model that from 2004/5 the DNOs will become cash negative like the water sector. The following table compares the water and electricity capex programmes in the context of RAV and Turnover. It shows that in monetary terms the electricity capex programme and the increase in

RAV after allowing for depreciation is around half that of water. However as a proportion of the opening RAV and turnover, capex and RAV increases are both greater than water.

	Water[1]	Electricity[2]
Opening RAV @ 1/4/05 (£bn)	35.3	11.9
Closing RAV @ 31/3/10 (£bn)	39.0	14.0
Change in RAV (£bn)	+3.7	+2.1
% Change in RAV	+10.5%	+17.6%
5 year turnover (£bn)	34.5	15.0
Change in RAV as % of Turnover	+10.7%	+14.0%
5 year capex (£bn)	15.7	7.0
Capex as % of opening RAV	44.5%	58.8%
Capex as % of turnover	45.5%	46.7%

We conclude therefore that the task of financing the increase in regulatory value, generally through retaining distributable reserves and increased debt, is no less onerous that that envisaged for water. Consequently, there appears to be justification for a cost of capital for electricity distribution at least equal to that proposed by Ofwat.

If you have any queries on the above please contact either Stuart Boyle (stuart.boyle@ngtuk.com) or myself.

Yours sincerely

[by email]

Tim Tutton

[1] Ofwat Periodic Review 04 Future Water and Sewerage charges 2005-10 Draft Determinations (2002/3 prices)
[2] Ofgem Electricity Distribution Aggregated Financial Model (2002/3 prices)