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Dear Martin,

Electricity Distribution Price control Review: Update paper

Thank you for the opportunity to comment on the above paper. Please find SSE's comments attached. We have also attached Appendix 1 and Appendix 2, both of which should be treated as confidential.

If you would like to discuss any of the comments made, please call.

Yours sincerely,

Rob McDonald
Director of Regulation

Metering

Overview

We have set out our detailed comments on the component parts of the metering price control below. However, we have two general concerns with the metering aspects of the price review. First, it is clear that much work remains to finalise the metering price caps. We would therefore welcome further discussion of the specific numbers before publication of the final proposals. Second, as part of that work we believe that Ofgem should consider the effect of its proposals on competition in metering.

In particular, we remain concerned that a traditional "cost plus" approach to setting price controls remains inappropriate in the context of a developing competitive market. In our view, a more appropriate approach, which would produce fewer risks to the development of competition, would be to base the metering price caps on market rates, rather than a broad "cost-plus" approach.

At the very least, we would expect Ofgem to carry out analysis to demonstrate that the metering tariff caps will provide "headroom" for new entrants. We would also note that such analysis was undertaken before Ofgem put in place supply price caps when the retail supply market was at a similar stage of development.

Meter Asset Provision (MAP)

Standardised MAP charge

We welcome the proposal to introduce common caps for all DNOs, and the revised methodology for asset recovery that has led to an increase in caps from the June proposals. We also agree the change to the allocation of operating costs and overheads. However, as noted above, we do not believe that the overall MAP tariff caps leave a great deal of "headroom" for new entrants, which will adversely affect competition.

Prepayment meters and Prohibition on Termination Charges

We support the letter sent from the ENA to Iain Osborne on 19 October. Ofgem's proposed methodology for protecting DNOs against stranding of PPM assets arising from early removal seems perverse. It merely increases costs to those suppliers who cannot/ have not de-appointed the host DNO. We believe it is entirely appropriate and cost-reflective that DNOs should be able to charge termination charges, in order to recover their costs incurred under the licence obligation, and that the supplier concerned should pick up those costs. Provided there is no "penalty" included in the termination charge we also fail to see how this could be anti-competitive.

Meter Operation (MOp)

Methodology

As also set out in the same ENA letter, we believe that there is still a long way to go to identify the appropriate revenue driver for MOp. Indeed, do not believe it will be possible to arrive at a revenue driver that is robust, given the variability in services provided year-on-year. In addition, the use of a revenue cap leads to the question about how under/over recoveries will be dealt with each year. Given the significant variation in activity levels, for example bulk tariff changes requested by suppliers and the meter re-certification programme driven to a large extent by Ofgem, significant under/over recoveries will without doubt occur. Without a "k" factor then a DNO would be in breach of its licence if it over-recovered.

However, the methodology which Ofgem has used to arrive at a revenue cap for MOp has in effect arrived at price caps for each MOp activity. We therefore continue to advocate that a few of these activities and associated caps are selected, for example the installation of a domestic credit meter, and other activities are linked to this by a non-discrimination clause as is proposed for MAP. Also, given that there is not much time left before the Final Proposals, we believe that this represents a pragmatic and reasonable solution.

More generally, we would urge Ofgem to carry out a robust assessment of the headroom available to new entrants as we do not believe that Ofgem's proposals would leave much scope for competition, particularly on Mop.

Revenue cap

In part, this arises because Ofgem's proposed 1.5% mark-up return is, in our view, simply insufficient. Metering businesses are not like supply businesses, they are more closely aligned to contracting businesses where mark-ups of 10-20% are common.

Inclusions and Exclusions

While we agree that the activities listed, such as revenue protection, should not form part of the metering price control (or even the distribution price control), we are not clear that treating them as excluded services would enable DNOs to choose whether to offer those services or not. That is, we are concerned that the non-discrimination clauses could prevent DNOs from entering into commercial bi-lateral contracts). We therefore believe that these services, which as the Update document emphasises are not part of the DNOs' licence obligations, should be unregulated.

Derivation of the Revenue Driver

As we have said above, we do not believe the approach to the revenue cap is appropriate. Volumes of activities will vary from year to year, possibly doubling or halving. Therefore we do not believe any of the suggested variables are appropriate.

Basic Services

We believe that Ofgem's concern about the mix of appointment times only arises under the revenue cap approach. Under a price cap approach we believe that defining a basic service as that provided on 1 June 2003 (under the JPW agreement) would work.

One Way Door

As proposed, a supplier will be able to "cherry-pick" and leave the DNO with the more expensive metering points to service. We are presently experiencing real examples of such "cherry-picking". The price control must therefore allow DNOs to recover an increasing average cost per metering point, as de-appointments take place.

We also believe that once a DNO has been de-appointed by a supplier at a metering point then the obligation should end i.e. a DNO would not be obliged to offer a service to that supplier. This would be consistent with phasing out the obligation. It would of course not preclude a DNO from entering into a commercial contract to provide that service.

QUALITY OF SERVICE AND OTHER OUTPUTS

Interruptions targets

We continue to believe that the benchmarking process is flawed. In our view, the arguments set out by Central Networks in their letter to Ofgem on 10 September on behalf of the majority of DNOs still apply, despite being dismissed in the Update document.

We firmly believe that an efficient DNO should be neutral to the incentive scheme. This is especially important given the proposal to increase DNOs' financial exposure to the scheme. Indeed, Ofgem stated early in the process their aim that the incentive scheme should be symmetrical i.e. there should be opportunities for outperformance/reward equal to the risk of penalty. In light of the targets set for SEPD in particular we do not believe that this has been delivered and we would therefore urge Ofgem to revisit the target setting methodology. In particular, we believe that Ofgem should focus on CONSAC and relative tree coverage, which are not separately adjusted for in the disaggregation model

Interruptions audits

We support streamlining the audit by breaking the audit sample into two sub-groups, such that if the first sample passes the 97% overall accuracy test, then the remainder of the sample will not need to be audited. This will reduce the audit workload and focus on areas where attention is most required.

Exceptional events

Treatment of severe weather events

We broadly support the proposed treatment of severe weather events. However, there are three areas where we have concerns. These are as follows:

- Category 3 events – We welcome the change in the threshold to 35% of exposed customers. However, the ENA wrote to Ofgem on 7 October pointing out that in the DNOs' view the relationship between the size of an event and the delay in the "clock starting" for compensation payments is not linear. The DNOs proposed a Square Law relationship. We understand that Ofgem are intending to accept the DNOs' proposal and if so we would welcome this;

- Lack of upper limit for the scale of an exceptional event – In the ENA letter the DNOs also advocated an upper limit or "Category 4" event. While we recognise that the Square Law rule and also the overall 2% cap help protect the DNOs from financial exposure, it is entirely possible that an event could happen so big that compensation amounting to tens of millions of pounds could be payable. Above the cap, DNOs would be able to pass these costs through to customers. However, in our view there has to be a policy limit on how far the customers who were off supply should be compensated by the remainder of the customer base. There could also be a huge administrative burden placed on DNOs, with little or no benefit to customers overall. Indeed Ofgem's own customer survey indicated that urban customers are not willing to cross-subsidise rural customers quality of supply; and

- Exclusion for the Highlands and Islands of Scotland – When developing the Interim Arrangements Ofgem agreed that the Highlands and Islands would be excluded from the scheme due to the unique circumstances (i.e. in order to bring about the economic electrification of the further north of Scotland the network had derogation from being developed to the same standard for the prevailing weather as for the rest of GB). The exclusion also recognised that severe weather is experienced more frequently in the north of Scotland and therefore SHEPD is more likely to hit the revenue exposure cap than other DNOs. This position has not changed, and we therefore believe it is unreasonable to expect the network to perform to the same standard as the rest of GB and we could not accept the quality of supply "package" without this exclusion.

Treatment of other types of exceptional events

We broadly support the proposed treatment of non-severe weather exceptional events which in our view achieves an appropriate balance of risk between small and large companies. By discounting only the CIs and CMLs above the threshold, it also reduces possible unequal/perverse treatments between companies that have just missed or just passed the threshold.

Changes in the exceptional event allowance

We welcome the increase in the allowance for exceptional events for SSE.

COST ASSESSMENT

Operating costs

We are broadly supportive of Ofgem's framework for setting operating cost allowances, including the normalisation work, the regression analysis, the use of the Upper Quartile and the refusing of glidepath. However, in our view, there are several issues that need to be addressed and these are set out below.

Regional factors

We have set out in appendix 1 a brief summary on the outstanding issues in relation to regional factors.

Frontier shift

While we welcome the revised efficiency assumption of 1.5% p.a., we remain strongly of the view that this significantly overstates the potential for future efficiencies. SSE's view is that 1% would be more reasonable. UK-wide productivity (which has historically been at least 2%) is captured within the RPI. Ofgem are therefore implicitly assuming 3.5% a year productivity improvement for electricity, plus frontier catch-up, which is above the range identified by Ofgem's consultants. The ENA wrote to Ofgem on 8 October with a further detailed critique of Ofgem's proposal, and we endorse that letter.

We also believe that Ofgem should give consideration to adopting something similar to Ofwat's 'carrot and stick' approach to this issue since we believe it strikes an appropriate balance between the interests of customers and shareholders, and importantly, strengthens the incentive for companies to seek out further opex efficiencies. For example, if Ofgem believe that the scope for future efficiency is in fact 1.5%, half of that target could be reflected in prices in advance with 50% of this removed from the proposals (i.e. a 0.75% frontier shift) to incentivise future savings.

Vegetation

We welcome the additional tree-cutting cost allowance.

Comparison with 2003/04 analysis

We are surprised that the opex roller has not been mentioned since the March policy document. This is of particular relevance to 2003/04 costs, and Table 4.2 in the Update document shows that 6 DNOs, including SHEPD, would benefit from this rolling incentive.

Ofgem were firmly committed to this in 2003 to avoid distorting incentives. To exclude such an incentive now could adversely affect investors' perception of the regulatory regime.

However, we recognise that further audit work may be required on the 2003/04 numbers and we therefore suggest that one option would be to explicitly recognise this as a "k" adjustment to allow revenue when that audit work of the 2003/04 numbers is complete.

Comparison with forecasts

In the Update document it is claimed that for SSE the allowances included in this paper are "at or above the level of the companies own forecasts". We are not able to confirm this as Ofgem have not provided the supporting calculations. However, this is to miss the fundamental point about incentives. As we have said on many occasions, Ofgem should expect efficient companies to earn more than the average return, otherwise there is little incentive to continue to drive the frontier forward. We have always advocated the use of "average costs" as the best way to achieve this. While we recognise that the use of the Upper Quartile moves towards recognising this in principle, it does not move very far.

Reward for frontier performance

It is apparent that the settlement for the industry is being driven by the efficiency of SSE and this has resulted in substantial benefits to customers. However, under Ofgem's current proposals there is no reward for being the frontier company. This contrasts with the last review where Southern was awarded an additional allowance of 1% of revenue in recognition of frontier performance. We also note that Ofwat have provided a mechanism for rewarding frontier performance. In addition, in the context of quality of supply, Ofgem have proposed a discretionary reward of £1.65m for WPD. Like WPD, SSE was recognised by the DTI and in the Ofgem determination as a benchmark company in the October 2002 storms. Nevertheless, it seems odd to offer a discretionary award for quality of service, but not operating efficiency. We believe that this needs to be addressed in the final proposals and a similar adjustment, as the last review (1% of turnover) seems appropriate.

Mergers

We still do not believe it is necessary to make adjustment for non-merged companies. As the Update document itself states, CN – East is an Upper Quartile company. We also do not believe there is any logic to the argument that mergers allow companies to accelerate the achievement of cost reductions. What they do is bring in new management with a focus on efficiency which was perhaps lacking before. This is a fundamental principle of incentive regulation.

The Update document briefly asks for comments on the value of the loss of comparators. We would point out at this stage that Ofgem's May 2002 policy document is very clear that this relates to loss of "management teams" not to loss of DNOs, and we agree with this principle. Therefore we fail to see how any detriment due to such loss of comparators can be linked to group size.

More generally, we firmly believe that the size and scope of the "merger penalty" will have important implications for the development of the sector. We therefore believe that this issue requires a much more detailed examination and consultation than set out in the September paper. Accordingly, we could suggest that the issue of the merger penalty should be subject to a separate consultation exercise after completion of the price review.

Rates

We welcome confirmation that business rates will be a pass-through cost, reflecting that these costs are uncontrollable costs within the price control period. This also takes into account that, whereas the rateable values have now been established, the UBR has yet to be set and Transitional Relief arrangements put in place. It is unlikely that these will be known before January 2005, therefore pass-through is even more appropriate.

Capital expenditure

We have set out a brief summary of our company specific issues on capex in appendix 2.

ESQCR

The ENA wrote to Ofgem on 8 October on behalf of the DNOs with regard to ESQCR costs. We believe that there will be without any doubt costs incurred before 1 April 2008, for example where there is immediate danger from a safety perspective. At present no allowance has been included in the price control proposals for ESQCR costs. Instead, DNOs are promised a review in 2008 once surveys have been completed. We do not accept this, and believe some 'contingency' allowance should be made in the Final Proposals or an automatic trigger should be included in the licence for cost claims as these costs are incurred. There has also been discussion in the working group considering the licence modifications of a 'materiality threshold' before a review of costs could be triggered. We would point out that a materiality threshold can only be consistent with a contingency level of costs having been allowed in the first place.

Sliding scale mechanism

We broadly support the sliding scale mechanism. However we strongly dispute the inference that the additional sliding scale capex allowance should be used for expenditures above the base case PB Power view. In particular, this should not be used to compensate for failing to set quality of supply allowances correctly.

Incentives

We remain firmly opposed to Ofgem's "threat" to weaken incentives to reduce operating costs during the next price control period. The existing regime has produced substantial cost savings since privatisation, to the benefit of customers. Any weakening of incentives will, by definition, reduce the *future* savings achieved. It is also clear that the "easy wins" have already been achieved and, accordingly, the up-front investment necessary to deliver future cost reductions is increasing. Now is not therefore the time to be altering the equation: customers' bills will be higher at the 2010 review as a result of higher costs if incentives are weakened now.

We believe that Ofgem have in mind aligning the incentives to reduce operating costs by introducing a sliding scale type mechanism which would return some of the benefit of cost reductions to customers either immediately or "logged-up" for the 2010 review. Such schemes tend to be fairly complicated, as illustrated by the equivalent sliding scale mechanism proposed for capex. That mechanism has been subject to detailed consultation since the June proposals. There have not however been any meaningful discussions with the industry about how this would work for operating costs. We are therefore faced with the prospect that a new and complicated incentive scheme for operating costs, that will have a profound effect on companies' future behaviour, will only be revealed to the industry for the first time in the final proposals. We are concerned that the introduction of such a major and complex reform so late in the process could lead to the development of a less than robust set of arrangements.

We understand that the primary driver for weakening incentives is Ofgem's concerns about the accounting policies of some DNOs and in particular capitalisation policies. We recognise these concerns, but we believe that weakening incentives will have a more direct and substantial effect on customers' bills than the detrimental effect of inappropriate accounting. We note, for example, that the price review team has been able to normalise companies' operating costs for the purposes of efficiency assessment and in setting operating cost allowances, despite these accounting issues.

We agree with Ofgem that the Regulatory Accounting Guidelines (RAGs) are the appropriate policy instrument for dealing with this issue. Industry standard RAGs should therefore be agreed and applied across the industry. We believe that this could be introduced within 12 months of setting the price control and in the interim Ofgem could make clear that the guidelines underpinning the business plan questionnaire will form the basis of those common rules going forward. We would commend this to the Authority as a way forward, but for the avoidance of doubt any weakening of incentives to reduce operating costs as part of the November final proposals would be unacceptable.

Financial issues

Cost of capital

We have set out previously why we consider that the allowed post-tax cost of capital needs to be in the range 5.25% - 5.5% in order to attract equity investment in network businesses. We have presented evidence in support of this range, including a detailed paper submitted to the Authority. We are also aware that other DNOs have submitted similar papers, including academic studies by NERA and OXERA. All of these point to a cost of capital in the above range. This is further supported by direct feedback to Ofgem from shareholders about required returns.

Regulatory precedent in other sectors also suggests that the cost of capital lies in this range, including water (5.1%, rising to 5.5% over time to address financing issues) *and* telecoms (above 5% on a like-for-like basis with electricity distribution using the same gearing assumption). Furthermore, a recent survey of investors indicated that 70% regarded the electricity sector as more, not less, risky than water. It is also apparent that there is greater regulatory risk in electricity than in water (for example, the degree of exposure to the IIP incentive). Finally, we calculate that the DNOs in aggregate will be significantly cash negative over the future price control period. These factors point to a higher, not lower, cost of capital than in water.

Ofgem have not engaged the industry on these issues, but have instead merely re-asserted the range of 4.2% - 5% which is derived from the theoretical CAPM economic model. Also, Ofgem have not put forward any objective evidence to explain why the other regulators' assumptions are inappropriate in electricity.

It is vital that Ofgem get this particular assumption "right", as the consequences of an inappropriate cost of capital would be substantial. Management time and effort would inevitably be diverted elsewhere in pursuit of possible investments that yield more attractive returns and innovation would also be limited. In addition, discretionary investments to connect new distributed generation, including upgrades of the transmission system, would be threatened. We also could not accept Ofgem's proposed funding of pension costs that provide for a significant proportion to be recovered via the RAV. This would put upward pressure on prices. For these reasons, we would urge the Authority to set a cost of capital within the range 5.25% – 5.5%. We recognise that the September update document has reduced the risk to the companies in a few areas, particularly in relation to pensions. This might therefore point to a cost of capital at the lower end of this range.

Base revenues

We have no issue with the 2004/05 revenue numbers or with the level of excluded services. However, when talking about the "p0 effect" it should be remembered that the allowed revenue in 2004/05 excludes EHV income which from 2005/06 will be included within the price control. The P0 increases are therefore not on a like-for-like basis and are being overstated.

Pensions

The 80% allocation to Distribution seems a sensible compromise. We also welcome the move from disallowing 100 per cent of ERDCs to disallowing only 30 per cent.

However, we disagree with disallowing 1/13 of the deficit to account for contributions in 2004/05. The ENA wrote on behalf of the DNOs on 5 October pointing out that DNOs do not expect to start deficit correction contributions until 2005/06. On a technical note, it is not mathematically correct to deduct 1/13 before applying factors and then taking a thirteenth.

Finally, we note that Ofgem intend to capitalise approximately 60% of the deficit recovery. While this seems sensible in principle, it is only acceptable if DNOs are allowed a sufficient cost of capital.

Tax

A lot of progress has been made on this issue since the June proposals and, although we do not necessarily agree the component parts of the calculation, the overall answer is about right. We would however still recommend a risk sharing mechanism for differences between the allowances and outturn tax.

Regulatory asset value

We have no major issues with the RAV roll-forward numbers shown in Table 5.4.

Other Issues

Losses

We have previously set out our concerns about the expected upward pressure on losses in the SHEPD area. In particular, we believe that, other things being equal, losses will increase as a result of connection of distributed generation. We continue to believe that this should be reflected in the final losses targets.

It appears to us to be particularly inequitable, against this background, that a target is being proposed for this area which is below the current loss percentage calculated on the proposed new basis. It is not clear what basis Ofgem has now used to set the proposed losses targets but DNO areas with generally falling levels of losses appear to stand to experience a relative benefit and those with generally increasing levels a relative loss if a target is set based on a 10 year average. As in other incentive schemes, Ofgem should endeavour to set targets that allow for the possibility of upside if performance improves as well as penalty if performance deteriorates. Targets should also be equally challenging for all DNOs as far as possible. In our view, the methodology for setting targets for the losses incentive has not achieved these two aims.

On other aspects of the incentive scheme, we note that the current draft licence modifications do not yet address the algebra required to effect the rolling retention mechanism. We expect that this will be very complex and still consider that some simplifying "NPV" approach might be useful. It will also be important to set out clearly for DNOs what criteria for assessing efficient capital expenditure on loss-reduction measures will be applied to give them the confidence to make such investments in the next price control period.

Distributed Generation (DG)

In our view, there are a number of areas where the exact details of the proposed scheme are still unclear, which is a matter of concern at this late stage of the price review process. DNOs have highlighted these areas in the response to the latest draft of the licence modifications and we regard it as vital that DNOs have a chance to understand and consider all aspects of the DG scheme before the final proposals are made in a month's time. We therefore urge Ofgem to provide the necessary clarity as soon as possible through the proposed licence modifications, the associated draft Regulatory Instructions and Guidance, and also relevant policy with respect to approvals of charging methodology statements.

We note below our specific remaining comments. Where the points have substantially been made in earlier documents, we refer to these and state our concerns only briefly.

Profile of Returns

As noted in our recent price control meeting with David Gray and emphasised in the recent letter from the ENA on behalf of all DNOs, there is a significant concern about the profile of returns under the proposed annuity approach to the pass-through term. Under this approach, returns are depressed in the initial price control period and significantly loaded towards the "back-end" of the project, which itself brings concerns about regulatory risk. For projects earning a moderate premium to the cost of capital, average returns in the first price control period would actually be significantly less than the cost of capital, and would not incentivise the connection of DG.

While we understand the policy rationale for an annuity approach, we do not believe that the RAV approach would produce sufficient variability in generator use of system charges to justify a change to an annuity approach to capital funding. In fact, as noted below, there are a number of factors that contribute to potential volatility of generator use of system charges. DNOs therefore need flexibility in the application of charge restriction conditions in order to be able to deal with these greater sources of variability in generator charges.

For these reasons, we would urge Ofgem to adopt a traditional RAV-based approach to capital funding in the DG incentive scheme.

Operating and Maintenance (O&M) Costs

We remain concerned that O&M costs have been set too low generally and that no account has been taken of the acknowledged higher than average costs of connection in the SHEPD area.

Essentially, we are concerned that the overall £/kW level of the O&M allowance is too low, taking into account present O&M cost levels and Ofgem's consultants' view that there are likely to be additional operating costs associated with the increasingly active management of DNO networks in the future. Furthermore, the new costs of ancillary services from DG, which are likely to become more significant as the proportion of DG on DNO systems rises, have not been taken into account. In our view, as distribution system operation becomes more complex, operating costs will rise and services from DG may help to mitigate the increase but they are not likely to reduce costs from current levels. In addition, the use of a single £/kW allowance across the industry does not recognise the higher cost of operating in the north of Scotland. As a consequence, we believe that O+M allowances should be based on 1½ % of relevant project costs, in line with the broad recommendation of Ofgem's consultants.

Constraints on Generation Revenue

In order for DNOs to finalise their approach to setting generator charges for 2005/06, they need to have clarity on both the price control constraints that will apply to the generator revenue stream and the cost base (for example, whether elements of rates and transmission charges are to be passed through) that such charges are to recover. These questions have come to the fore due to the development, in the draft licence modifications, of two separate components of overall distribution allowable network revenue, namely one relating to demand charges and one to generator charges.

A separate correction factor for generation-related distribution revenue has also appeared in the draft licence modifications relating to the DG incentive scheme. Given the potential forecasting uncertainties and volatility surrounding the growth of DG revenues, together with Ofgem's stated desire to see price stability in generator charges, we consider that flexibility in treatment of generation under and over-recoveries will be required. More detail on this issue has recently been provided in the DNOs' commentary on the DG licence conditions but, in essence, we consider that there should be no financial penalty for DNOs who attempt to smooth the volatility of generator charges from year to year. This might be achieved, for example, by removing any penalty rates on generation-related recovery positions for the next price control period and/or by continuing to apply some aspects of the charge restriction conditions only to the combined distribution network revenue.

Network Unavailability Payments

We remain fundamentally opposed to the concept of network unavailability rebate payments to generators, which has been raised in previous consultations. The DNOs' general point on Ofgem's powers to introduce such a mechanism under the licence or subsidiary documents is relevant here and we would welcome early clarity from Ofgem that they will no longer be taking forward any policy development in this area.

Operation of the Pass-Through Term

While we understand the logic behind the form of pass-through term that Ofgem has constructed, there are still some concerns with the operation of this term. For individual projects, although not necessarily for the portfolio as a whole, this term could easily become negative where there is a significant element of customer-funded shared-use assets. This would particularly be the case for projects above the high-cost threshold, which suggests that some floor on the value of the term in individual cases would be appropriate to prevent perverse effects in such cases.

Updating the Allowances

The £/kW incentive allowances have been set based on 2002/03 cost projections and an assumed cost of capital of 6.5% pre-tax. The figures need to be updated for the base revenue year of 2005/06 and the final assumptions on cost of capital.

Stranded Assets

We believe that there are still risks for the DNO with the current proposals that the MW expected from a particular DG scheme do not materialise or disappear within the depreciation life of the assets. It is inequitable, in our view, for DNO investment to be at risk of returns less than the cost of capital due to risks affecting their DG counterparties. The commercial environment in which DG developers operate requires rates of return considerably in excess of those of regulated utilities to cover their risk profile. It is reasonable for DNOs, therefore, to seek to protect their returns through capacity tie-ins and termination payments to cover the situation where a DG scheme fails part way through the assumed depreciation life.

Specific Re-Opener

The DG incentive scheme is a complex and untried mechanism, which will govern the return on significant sums of DNO investment over the next price control period. We continue to believe that a specific 're-opener' mechanism is necessary, which would enable a DNO to require Ofgem to undertake a review of the need (if any) to modify or revoke the incentive scheme in certain circumstances. We consider that these circumstances should be as follows: firstly, any material unforeseen change in the government's renewables policy and, secondly, any material adverse unforeseen consequences in the operation of the incentive scheme itself. A DNO should be able to trigger a reference of the matter to the Competition Commission if Ofgem did not agree that the circumstances warranted a review.

P2/6

A further consideration in this area relates to the new P2/6 planning standard which, after a period of development by the industry, is expected to be out for wider consultation in the near future. The essence of this new standard, intended to replace the existing P2/5, is that a DNO ought to be able to rely on a contribution to system security from DG, which may offset or defer the need for conventional system reinforcement.

This raises the question of how a DNO is to be rewarded for helping to install DG instead of new network. The £/kW term in the hybrid DG scheme is unlikely to be sufficiently attractive to offset the lower revenues from a lower RAV (because of investment foregone). In other words, the incentive from the DG scheme is probably not going to be sufficient to positively encourage DNOs to seek out DG in place of network capex. It therefore appears to us that any additional costs from a new P2/6 standard which is adopted mid-price control period should be a candidate for the proposed uncertainty mechanism.

IFI Scheme

A remaining issue for the IFI scheme in our view, is the requirement for DNOs to be certain that, once funds are committed to IFI projects, the appropriate pass-through element will indeed be added to allowable revenue. The June RIGs document outlined a two-stage information process for IFI schemes, whereby budget information is presented before the start of the relevant financial year and outturn financial information is provided after the end of the financial year. It will be important, for the purpose of reducing regulatory uncertainty in this area, that Ofgem commits to a process of formally accepting the projects put forward by DNOs for pass-through of all expenditure at the appropriate rate. In our view, this process should be set out in the licence conditions.

RPZ Scheme

We have been concerned to learn of Ofgem's intention to use a uniform RPZ incentive rate of £3/kW across all DNOs. The additional average cost of connecting DG in SHEPD's area has been recognised in the main incentive rate for this area, at £2/kW compared to £1.50/kW elsewhere. It seems perverse, therefore, to effectively reduce the potential reward for RPZ schemes in SHEPD's area by making the additional premium for RPZ schemes only 1.5 times the main incentive rate rather than 2 times, as for other DNO areas. Such an approach would weaken the incentive for SHEPD to seek out opportunities for RPZ schemes and we urge Ofgem to commit to an RPZ premium equivalent to double the main £/kW incentive rate in this DNO area.

We remain concerned about the relatively low level of the proposed funding cap per DNO per year (at £0.5m) for RPZ schemes. At the very least, there should be a mechanism set out in the licence conditions to establish a rolling "correction factor" for any under-recovery against the funding cap in the earlier years of the price control.