CE Electric UK

Our Ref: jmf/sa/100807

Your Ref:

Date: 9 August 2007

Martin Crouch
Director, Electricity Distribution
Ofgem
9 Millbank
LONDON
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Dear Martin,

DPCR 5 – Looking Ahead

Thank you for the opportunity to contribute to your development of the approach to the forthcoming price control review (DPCR 5), as outlined in your letter of 17 May. I write here on behalf of both Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL), the licensed electricity distributors of CE Electric UK Funding Co (CE).

The forthcoming review is being conducted against a background of changed statutory duties for the Gas and Electricity Markets Authority and the EU's agreement on a binding 20% renewable energy target. These changed strategic drivers suggest a wide range of issues to discuss, reflecting global concerns over security of supply and the environmental impact of human activity. Some of these issues relate to an increased role for distributors, whether incremental (such as supporting smart meter roll-out) or radical (such as trading energy services).

We stand ready to pick up any of these new activities, so long as they are consistent with the rest of our business. This means both that there should be scope for a fair return, and that the new work should yield some synergies with mainstream distribution activity.

Although this review offers a timely opportunity to consider the role that distributors can play in the promotion of a low-carbon economy, we also recognise that, in the immediate future, distributors will continue to carry out many of the same activities that they have always carried out. Many of the important issues that have been considered at previous reviews will appear again at this review. At this stage it appears to us that:

- the five-year duration for the price control should be retained as a reasonable balance between the incentive power of the regime and the uncertainty of future cost projections. However, the view of the next five years that will inform the review must take account of the work being carried out by Ofgem on the development of long-term scenarios;
- the review must recognise that electricity distribution assets are long-lived assets that are remunerated over several review periods. Although we agree that we should retain the five-year price control horizon, we believe that this needs to be balanced by an acknowledgement that the allowed cost of capital must offer the prospect of reasonable returns over the lifetime of the asset;

- opportunities for out-performance in operating and capital costs have diminished over the DPCR4 period which has seen significant rises in commodity and service costs. Against this background we believe that the regulatory regime must retain and, where possible, enhance the incentives for operating and capital efficiency;
- at a time where we are undoubtedly facing a period over which investment in the networks is a particularly important feature of the sector's activity, the sliding-scale capex efficiency incentive should be retained but recalibrated to provide better incentives for forecasting accuracy;
- the 50% weighting on units distributed in the growth term of the present distribution charge restriction formula introduces risks into the regulatory process that serve no useful purpose, as has been demonstrated by the recent downturn in units distributed that was not anticipated when the formula was set. The formula for the next regulatory period should be better aligned with cost drivers and with the Government's and the Authority's environmental agenda; and
- not only must the quality of service targets set for the DPCR5 period be derived from robust and comparable data, but the targets must also take account of the historic levels of investment in each network. To do otherwise would render the process illogical and unfair.

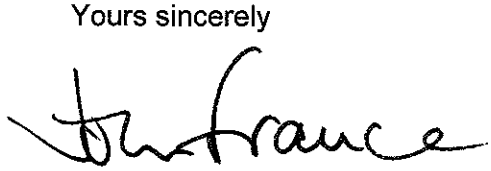
From a process point of view, key issues for the conduct of the review include:

- the need for a robust and transparent process. We believe that the September update at previous reviews played a useful part in the process and whilst we are open to Ofgem taking a different approach to how it openly communicates the development of its thinking in the crucial latter stages, we would be opposed to any changes that reduce the opportunities afforded to the licensees to interact with Ofgem staff on the key issues of debate and to be properly notified of the status of any changes that are being considered. Hence, we strongly recommend that there should be a quantified statement (or series of statements) on the key positions around September 2009; and
- securing the early deliverables for this project, specifically:
    - the future of the sliding-scale capex incentive, to encourage accurate forecasting; and
    - the IIS incentive rate, to manage the transition of QoS improvement programmes between review periods.

A more detailed discussion is attached.

We look forward to continuing to develop this project with you, and are ready and willing to help develop workable solutions to this wide range of issues. Given the strong overlap we see with the development of long-term scenarios, I am sending a copy of this letter to Robert Hull.

Yours sincerely



John France
Regulation Director

CE Electric UK

DPCR 5 – Looking Ahead

CE Detailed Response

Summary

We welcome the opportunity to comment on the framework for the review, and specifically support both the timeliness and wide-ranging scope of Ofgem's letter. There is clearly a wide range of issues to discuss, reflecting new strategic drivers such as binding EU targets for greenhouse gas reductions.

This range of issues confirms that we are embarking upon what is truly a periodic review of the outcomes we require of distribution networks and the price that customers are prepared to pay, rather than simply seeking to restrict the prices of 'known' outcomes.

Some of these issues relate to the core conventional wires business, such as continuous improvement in efficiency of delivery and in levels of customer service. Others relate to an increased role for distributors, whether incremental (such as supporting smart meter roll-out) or radical (such as trading energy services).

We stand ready to pick up any of these new activities, so long as they are consistent with the rest of the business. This means both that there should be scope for a fair return, and that the new work should yield some synergies with mainstream distribution activity.

We see the key issues for this stage of the periodic review project as:

- we must retain the rewards for outperformance on mainstream distribution activities that have allowed significant reductions in cost and improvements in service to be delivered to customers since 1990. In a period when input costs are rising, it is even more important to provide strong incentives to genuine efficiency. Following this, we should also provide for scope for outperformance in new outputs and incentives;
- as markets become more sophisticated, we need to clarify the respective rights and responsibilities of suppliers and distributors. There is scope for distributors to play a more commercially active role in bringing forward energy efficiency and distributed energy, moving into some activities at the blurred boundary between the two licensed activities;
- we should use the long-term scenarios project to develop a position on the roles and responsibilities of distributors. Radical commercial and engineering solutions must be considered. From this, we can derive a set of desired outcomes and purposeful incentives;
- we need an holistic approach to both outcomes and incentives. A piecemeal approach would be likely to lead to both conflicting requirements and perverse incentives;
- reinforcing behaviours requires clear and strong incentives. Therefore, better regulation requires clear and predictable rewards related directly to the efforts of distributors, reflecting value, cost and risk and isolated from externalities. Mechanistic revenue drivers are well understood by the industry and, where linked directly to distributors' efforts, have worked well for 17 years;
- cost assessment must include the cost of capital. Securing long-term funds for long-lived investment requires stable returns, rather than chasing a volatile short-term debt market;
- we agree that whole-life costing and capex/opex/performance trade-offs are key areas to develop, but first we need to establish a common language. We need both to establish a working definition of what (for example) whole-life costing means, and also to ensure that the base figures used are truly comparable;

- having a robust and transparent process requires that a quantified position be published in or around September 2009. We accept that this need not necessarily be a full formal consultation document, but we would expect at least a set of key figures to be presented by Ofgem at the proposed September 2009 workshop; and
- there are some early deliverables, specifically:
    - the future of the sliding-scale capex incentive, to encourage accurate forecasting; and
    - the IIS incentive rate, to manage the transition of QoS improvement programmes between review periods.

Overview

We note that the open letter is relatively short, and does not address many of the issues we would normally expect to see in a price control consultation paper. We appreciate that this is not a conventional consultation and welcome the way in which Ofgem has adopted a logical approach of addressing the key questions of principle before developing a detailed methodology.

Given the changing context of electricity distribution, we agree that we should first review the strategic drivers, then define a new set of outputs for distributors. If we believe that more renewable generation and lower energy consumption are required, and that current arrangements are not acting quickly enough, then we should consider radical changes to the role of distribution.

This might mean taking on responsibilities more normally associated with suppliers, such as aggregating generator output or providing energy efficiency services. It could also require a change in focus for network design and operation from securing demand, with generation as a secondary flow, to facilitating generation, with some compromise of demand customers' current rights.

We have found it helpful to consider the wide range of issues raised by Ofgem in the order of:

- strategic drivers;
- objectives for the periodic review process;
- in that context, roles and responsibilities of licensed electricity distributors and hence:
    - desired outputs; and
    - incentives to drive those outputs;
- cost assessment; and
- the process of the review project.

This response is therefore constructed along those lines.

Strategic Drivers

GEMA's own duties have evolved since the last periodic review, so we agree that it is appropriate to consider the strategic drivers for the regulation of electricity distribution licensees.

Our first priority is the safety of the public and our staff. We follow HSE's guidance on eliminating danger unless the costs are grossly disproportionate, as laid out in their paper *Reducing risks, protecting people*. This and the more specific requirements of the Electricity Safety, Quality and Continuity Regulations 2002 (and regulations made under the Health and Safety at Work etc Act 1974) are key drivers of distributors' activities. The issues include:

- reducing inadvertent contact with overhead lines;

- reducing unauthorised access to substations;
- eliminating overloaded and overstressed assets;
- generally maintaining our assets in good condition;
- minimising work at heights; and
- managing the health risk from asbestos.

It is therefore essential that our quantified programmes to address these issues through maintenance, replacement, reinforcement and enhancement are fully funded.

We concur that the EU agreement on a binding 20% renewable energy target is a key driver, which sets the scene for a discussion of the roles and responsibilities of distributors. To explore this in more detail, it seems appropriate to consider the Government's four goals for energy policy:

- to put ourselves on a path to cut the UK's carbon dioxide emissions by some 60% by about 2050, as recommended by the RCEP, with real progress by 2020;
- to maintain the reliability of energy supplies;
- to promote competitive markets in the UK and beyond, helping to raise the rate of sustainable economic growth and to improve our productivity; and
- to ensure that every home is adequately and affordably heated.

These are reflected in the Secretary of State's statutory guidance on social and environmental issues, including expectations for the Authority to:

- take into account the Government's belief that investment in renewables, although they may be more costly in the short term, is needed now in order to meet our longer-term carbon targets. This raises the question of whether we should permit a short-term increase in distribution costs, to make the network more ready to accept generation, to serve this wider aim;
- help promote CHP and energy efficiency by ensuring that barriers inhibiting progress are removed wherever possible. This echoes duties placed on the Authority by the Utilities Act 2000 to promote the efficient use of electricity conveyed by distribution systems. This extends beyond using sharper pricing to encourage more efficient use of the distribution system itself, to the prospect of distributors actively promoting CHP and energy efficiency. The greatest value could be released from these measures when integrated with the design and operation of the distribution (and potentially transmission) systems; and
- take steps to provide a framework within which businesses and the economy generally are encouraged to work towards a radical transformation of the energy system to one that is more diverse with a greater mix of energy, especially electricity sources and technologies, and greater diversity both in supply and the control and management of demand. This is likely to require the development of energy services markets. Such markets could be served by distributors, either where integrated with distribution system operation, or in the case of market failure.

The radical transformation of the energy system called for by Government calls for an equally radical review of the role of distribution, and how regulation can support the transition. If we do not change the way we regulate distribution businesses, we cannot transform their operations.

Objectives for the Periodic Review Process

We agree with the objectives laid out in the open letter, specifically to:

- facilitate sustainable development and investment where it is needed, to promote secure supplies and good customer service, and to ensure the networks and network operators change to meet the new challenges they will face;
- enable better-performing companies to earn higher returns. Generally, we hold that this should be through a framework that provides clear targets and clear rewards, so that any company can earn higher returns by performing better. We hold that, by their nature, discretionary awards and league tables offer weak incentives and thereby act against the best interests of customers[1]; and
- gain the confidence of investors and other stakeholders to secure the increased investment that will be required.

We support the retention of a five-year review period, which provides a fair balance between flexibility and predictability. This must be set within the context of the long-term development of long-lived assets to meet long-term social and environmental objectives. Therefore, as will be explored in more detail later, understanding the roles and responsibilities of distributors through developing long-term network scenarios is essential.

Roles and Responsibilities of Licensed Electricity Distributors

We agree that it is appropriate to consider the scope of the electricity distribution licence, and of the regulatory mechanisms (including price control) that accompany it.

In principle, we support expanding the role of distributors. We stand ready to help Ofgem better meet its objectives, both in the review process itself and by taking on additional responsibilities.

However, we should take this step only where there are clear advantages of doing so, i.e. where leveraging the core abilities of distributors will add value, and where adding that value is fairly rewarded.

We need to take an holistic approach to roles and responsibilities, to ensure that distributors and suppliers each have a balanced package of outputs that they can reasonably and efficiently deliver. In broad terms, we can see three possible roles for distributors, which we might loosely describe as business as usual, environmentally-aware operation and driving a low-carbon economy

Taking each of these in a little more detail:

- business-as-usual means continuing to operate networks led by standards (e.g. ER P2/6 and ESQCR, in turn set primarily for the protection of demand customers), with marginal investment to accommodate DG and improve service. This is consistent with a business-as-usual price control, dominated by the costs of routine maintenance, reinforcement and replacement, with 'Y factors' to fund DG connections, CI/CML reductions, losses reductions, etc;
- environmentally-aware operation means adopting the same commercial position and (broadly) service offering as business as usual, but discharging that role in a way that has lower impact on the environment, e.g.:
    - introducing assets and network configurations with lower losses;
    - encouraging more efficient use of the distribution system, managing both constraints and losses; and

[1] For example, we accept that the use of yardsticks at the periodic review is a useful tool, although subject to the limitations of the data used. However, the investment decisions made afterwards require a clearer framework. We can readily justify capital spend where we understand the likely returns as, for example, under the current IIS. If the reward for any investment depended upon the company's position amongst its peers, the reward would be much less certain and the investment therefore much less likely to be justifiable.

  - reducing the environmental footprint of our operations.

  This is consistent with a business-as-usual price control, modified by (for example):

  - a higher value for losses,
  - new incentive for SF6 reduction (as for the transmission Owners (TOs)); and
  - more sharply-defined use of system pricing signals; and

- driving a low-carbon economy means designing a network around distributed energy sources rather than demand, and driving energy efficiency for customers and the network. This requires a radical change to current regulation, to change the focus from securing demand to pulling through energy efficiency and distributed energy.

  The current price control tends to reward the installation of assets and the minimisation of risk. Achieving the more radical vision presented here requires a price control based upon the delivery of a service, recognising that innovative solutions may require fewer assets but place greater risk on distributors.

Outcomes and Outputs

Understanding strategic drivers and the objectives for the periodic review process allows us to assess a wide range of options to expand the role of distributors. As will be discussed later, we submit that these should be assessed in the long-term scenarios project, so that we can understand which will best contribute to the timely and efficient development of a low-carbon power system.

We agree with the need to reduce our carbon footprint, which is part of the broader need to reduce greenhouse gas emissions. We agree that there is scope to measure accurately and consistently and then reduce:

- genuine engineering network losses, through introducing:
  - new asset specifications;
  - alternative network configurations; and
  - sharper signals for users to change their patterns of usage;
- distributor's own-consumption of electricity at their own substations and other sites;
- carbon emissions of vehicles and mobile plant; and
- SF6 release.

We note that there are existing measures here, both within Ofgem's remit (e.g. the existing losses incentive) and without (e.g. the Renewable Transport Fuels Obligation (RTFO) and the commercial Carbon Reduction Commitment (CRC)). The next price control could build upon these, to provide yet stronger signals.

On a related issue, we submit that the review should consider noise and visual amenity. We welcome the introduction at the last review of an allowance for placing underground lines running through sensitive areas. We suggest that it is worth considering customers' willingness to pay to extend this scheme in size; geographic coverage (i.e. beyond the AONBs and national parks); and function, to address noise as well as visual amenity.

We note Ofgem's recent conclusion that competition, rather than a 'one size fits all' regulated solution, is the best way to deliver smart metering, and that suppliers are best placed to understand the costs and benefits to different types of customer and deliver the types of meter that customers want.

If smart metering remains as currently specified, focussed on the provision of information, we support this approach. There seems to us to be little merit in returning metering obligations to distributors simply as providers of assets specified and used by third parties, but, if the market fails to provide, we stand ready to help.

However, we are concerned that the proposals may be too modest and short-sighted and would encourage further consideration of some more radical options. If we adopt a more radical, holistic role for distributors, there is a stronger case for distributors taking the lead on smart metering roll-out as part of an integrated package of active power systems management. We could use the two-way communication element of smart metering to control more flexible demand and generation.

Similarly, there seems to us to be:

- little merit in simply using existing statutory powers to impose a carbon emissions reduction target on distributors; but
- value to be realised if, for example, distributors were to lease *and despatch* micro-generators or demand-side carbon reduction measures. Equivalent solutions already exist in North America, where utilities lease and despatch key loads in domestic and commercial premises. This would not greatly disrupt existing arrangements between customers and energy suppliers, as there would still be a need for the householder to buy gas and to buy (and perhaps sell) electricity.

A variation of this would be for distributors to perform some kind of aggregating role in trading the output of such generation in the wider market. As transaction costs are prohibitively high compared with the current economic value of each export stream, there is scope for novel solutions for distributors to act as an honest broker to unlock the inherent value to society, the economy and the environment.

Similar principles apply to other innovative energy efficiency measures.

We agree strongly that the relationship between transmission and distribution needs to be reformed, hence our active engagement in Ofgem's working group on Transmission Arrangements for Distributed Generation (TADG)[2].

Our key and immediate concern here is the need to make sensible connection offers to potential distributed generators. We must therefore resolve the 'exporting GSP' issue. This requires that we establish what transmission access rights are required for distributed generators, and who should hold them. The scope of the recently-announced Transmission Access Review might explicitly include consideration of this issue.

We agree that an agency role is appropriate for smaller generators: we need to establish whether distributors or suppliers should be that agent. We suggest that we can either

- continue to refine the business-as-usual position, which suggests to us that suppliers take on the bulk of the agency role; or
- move to more radical solutions, where distributors actively encourage energy efficiency and the connection of renewable generation, which suggests to us that distributors take on the agency role.

  However, this then requires that we consider the Distribution System Operator agency option (previously ruled out as being too complex) because, if we do not take an holistic view of the role of distributors, we shall end up with an inconsistent mix of rights and responsibilities.

  For example, taking on an agency role to specify and fund transmission access requirements for distributed generation makes little sense if not balanced by an equivalent obligation for demand. This has to link to the price control treatment of exit charges, so we have balanced incentives between:

  - transmission reinforcement;
  - distribution reinforcement;

[2] we are also active on Ofgem's Distributed Energy Working Group, although this work seems to us more relevant to the way in which we would like to see the long-term scenarios developed

- generation constraint; and
- demand constraint.

Similarly, if distribution-connected generation is to be treated on the same basis as transmission-connected stations, then there is a case for the output to be bid explicitly into the Balancing Mechanism. If distributors are to be exposed to imbalance charges, they need the ability to despatch generation. Again, it seems logical to extend this to demand.

If distributors are to trade capacity with the GB System Operator, there is a case for them to trade other services, such as reactive power and short-term operating reserve.

These issues bring us back to the concept of a network-focussed energy services provision role for distributors, as outlined in the earlier discussion on energy efficiency.

We agree that the need to sustain competition requires a review of unbundling distribution from generation and supply. This should start from understanding what roles we wish distributors to discharge, which might include some activities at the distribution/supply boundary. These have been discussed earlier, and include agency roles for smaller generation and promoting energy efficiency.

This does not mean that we should change the fundamental principles of separating retail supply issues from the mainstream wires business. Rather, there is a set of new activities, such as the agency role for distributed generation, that were never carried out by PESs because there was little requirement at the time. Now the need to promote energy efficiency and green generation more actively is growing, we need to define in which part of the ex-PES activity these responsibilities best sit.

We do not believe that mandating competitive tendering is relevant to the regulation of distribution businesses. We agree that incentive regulation has led to sustained improvements in quality, investment and efficiency. Part of this has been the increased use of contractors and consultants by licensees. We tender out work where it is economic: the balance between in-house and outsourced will be different for every group.

If current incentives are not strong enough to continue to force distributors towards the frontier, then those mechanisms need to be strengthened. Given the limited resource (not least time) available to us and the wide range of issues to consider in this periodic review, we suggest that we would be better focussed on retaining strong incentives to efficiency overall, rather than diverting onto this side issue.

Customer service is one of our key priorities, and Quality of Service remains a key output for our customers. While some research is needed to validate current key concerns and willingness to pay, our initial feedback shows that, while headline (IIS) performance is important, it has little direct bearing on individual customers' experience. The extremes, such as multiple and extended interruptions, seem to matter more. This brings us to consider investment in resilience, which takes a number of forms:

- widespread programmes to remove generic weaknesses, e.g. small-section conductor HV OHL (7,000km in CE alone), which extends restoration times in storm conditions due to the sheer number of incidents; or
- more focussed programmes to minimise the risk (either probability or consequence) of events that would probably be few in number but have potentially widespread impact, e.g. at primary substations and bulk supply points:
  - flood defences; or
  - enhanced interconnection.

We cannot assume similar outcomes for all licensees. Past investment decisions, some going back over decades, influence the present level of service. IIS targets must be calibrated to reflect accurate data and the investment made (or required) to achieve leading

performance, so that customers do not pay both for the capital investment made and for the IIS reward. Conversely, where such investments have not been made and are therefore not being remunerated through the regulatory asset value (RAV) it would be wrong to penalise companies for achieving a lower performance standard.

Another aspect of customer service not specifically mentioned in the open letter is that of making connections. We welcome the recently introduced standards for processing applications. We know that this is a key customer interface for us, and we strive to meet the highest standards. Leading performance in this area should be recognised.

There is also a more general issue of encouraging us to innovate, take balanced risks and be generally more pro-active in how we design and install new connection assets. We currently lack a scheme to reward such behaviours, where a strong and explicit incentive on the number of sites connected may be appropriate. This follows the recurring theme of rewarding us for providing a service rather than installing assets. Generally, more risk means fewer assets, and delivering these efficiencies must be rewarded.

Long-Term Scenarios

We agree that:

- a five-year duration for the price control remains appropriate; and
- networks and network operators need to change to meet the challenges we face more effectively.

Therefore, we strongly support the development of a range of long-term scenarios, to ensure that the forthcoming five-year control is set firmly in the context of the long-run development of long-lived assets to meet long-term social and environmental objectives.

We submit that a key question that these long-term scenarios can help answer is that of the role and responsibilities of the distribution business. For example, as discussed earlier, we can conceive of a range of possible roles for an electricity distributor including:

- primarily to support demand. This is a commercially passive role, with:
    - network development led by standards, established primarily to protect demand customers, in response to changes in usage;
    - generation accommodated as a marginal flow; and
    - other enhancements (e.g. to visual amenity or QoS performance) made as investments marginal to the main demand-centred activity.

  This is, broadly speaking, the approach taken in the existing work referred to in your letter; or
- primarily to support a low-carbon economy. This becomes a more commercially active role, with:
    - network development led by the need to facilitate flows of low-carbon energy, driving changes in usage; and
    - some compromise of users' existing rights, e.g. through distributor dispatch of both generation and demand, to maintain reasonable levels of quality and continuity of supply.

These different aims will result in different outcomes. For example, the latter option creates the potential for distributors to provide energy services to end-users, releasing benefits to the local distribution system and/or aggregating services for the national market.

These scenarios involve changes to commercial arrangements as well as engineering standards. They will probably require changes to regulation, at least where expressed as incentives.

We see a key output of the long-term scenarios work as being a high-level cost-benefit analysis of the more radical solutions, to see whether evolutionary or revolutionary approaches will better meet social and environmental objectives within acceptable timescales. This analysis will allow us to lay the foundations for the new regulatory framework.

Following from this, we suggest some changes to the approach to developing those long-term scenarios proposed in the 15 June open letter, specifically that:

- the project explicitly includes (likely in phase 2) the fundamental issue of what the primary role of distribution networks in supporting low-carbon economies should be. This would change the focus on drivers from the set originally proposed, which are perhaps secondary to the wider social and environmental issues discussed in this paper;
- the outputs of the scenarios be constructed around reasonably detailed network architectures (commercial and engineering) that would support those roles;
- the final report be delivered in February 2008 rather than May, so that it could then inform the DPCR 5 initial consultation. This would in turn allow the more viable scenarios to be reflected in the FBPQ questionnaire and companies' submissions; and
- to facilitate this more aggressive timetable, the analysis of the 2025 waymarks be dropped. Instead, we suggest that the radical '2050' forward view be back-cast directly to the 2010-15 period.

Incentives

We contend that, before we discuss incentives, we must first define the outcomes and outputs we expect. Therefore, this paper does not go into great detail on the incentive mechanisms that may be appropriate to bring forward any given set of outcomes, but instead makes a few more general points.

Reinforcing desirable behaviours requires clear and strong incentives. Mechanisms that do not provide clarity of reward will not bring forward significant investment of management time or shareholders' funds. This category includes:

- 'league table' regulation, where rewards are based upon a company's position relative to its peers; or
- 'discretionary' awards, where rewards are based upon some ex-post assessment with unclear rules.

We welcome and attach importance to Ofgem's recognition of our efforts continuously to improve customer service. However, we cannot make a rational, quantified, business case for significant investment on the basis of a regulatory mechanism that is entirely discretionary in its operation.

It would be helpful for Ofgem to clarify what is meant by 'a package of commitments from each licensee with funding conditional on delivery'. While incentives based on outcomes are generally in customers' best interests, funding based on outputs can be useful where such outcomes cannot directly be measured.

One such instance is the existing mechanism for iron gas mains replacement. This could be extended to the increasingly important area of resilience, for example:

- reinforcing rural systems[3] to give network topologies (and hence performance) closer to national standards; or

[3] The example here is the 20kV system in Durham and Northumberland. The issue is not the 20kV circuits, which perform well km for km. Rather, this system voltage permits the use of long feeders and hence relatively few primary substations. If this system were fed at 11kV, there would be far more primaries and hence shorter circuits and better performance, but there would be more assets. We are not seeking to rebuild the 20kV system, but to reinforce the 66kV system that sits behind it, so that these customers enjoy the level of performance they would elsewhere in the country (e.g. North Yorkshire)

- eliminating small section (0.025□" and below) conductor. This might usefully be expanded to cover upgrading these lines from single- to three-phase, boosting the rural economy by aiding the connection of demand and community generation.

This kind of programme will not be brought forward under the current regulatory framework.

One key point is that any funding cannot be made conditional on delivery of the entire package. We should only be paid for what we deliver, but we should still be paid for all we deliver. To have what might be significant investment unfunded for what might be a relatively small shortfall elsewhere would be unacceptable.

We support the continued use of the 'sliding scale' two-part capex incentive. This requires only minor review, to ensure that incentives to accurate forecasting and effective investment are retained. The issue here is that, beyond the numbers, the current version fails to take account of undue risk aversion and the benefits that managers may perceive in having a cushion against over-spend. If this incentive is to be meaningful, it must be settled well before the FBPQ is issued, so that it influences the way in which companies construct their forecasts.

Opportunities for opex outperformance are restricted in a time of rising commodity and service costs. In a time when input costs are rising, it is even more important to provide strong incentives to genuine efficiency across all cost categories. Amongst other things, this requires the cost assessment process to give meaningful recognition to the likely forward increases in input prices that the licensees face in the forthcoming period.

We support the principle of better regulation, but this does not necessarily mean fewer mechanistic revenue drivers. These are well understood within the industry, and experience shows that such mechanisms work well to modify behaviour. Simplicity in the design of the regime has some value but it is not an objective that should be pursued to the detriment of other more valuable objectives The issue here may be more one of presentation than of reimplementation.

Investing management time and shareholders' funds requires clear and predictable rewards related directly to the efforts of distributors. These should balance the value to customers and the likely cost and risks to companies. Wherever possible, to manage that risk and reduce windfall gains, such rewards should be isolated from external events beyond companies' reasonable control.

This highlights the shortcomings of the current growth driver. Incentives to distribute more units are hard to reconcile with the Government's and the Authority's environmental objectives. The number of units distributed is a poor proxy for the factors that drive a distributor's costs. External events have also given rise to both shocks and windfalls.

Where costs are uncertain, incentive rates should be set according to the value of the output to be delivered. This will include customers' willingness to pay, and social and environmental benefits such as the cost of carbon. Distributors will then seek out such objectives to the point where their costs outweigh the likely rewards. We should not be afraid of paying a short-term premium to reveal the efficient cost of delivering new outcomes.

There is a range of ways of implementing strong and clear incentives, including:

- structural measures, e.g. the DPCR 4 opex incentive and DPCR 3 capex incentive. Here, the operation of the standard RPI-X price cap allowed companies to retain 100% and 39% respectively of any efficiencies they delivered;
- target and penalty. If an outcome is deemed sufficiently important that licensees should not have discretion as to the level of service, a simple target and Ofgem's existing enforcement powers would ensure efficient delivery, so long as adequately funded in the settlement; and
- formal mechanisms. These may be revenue drivers, as the current IIS, or conditional RAV additions akin to iron gas mains replacement.

We should review the use of each of these to encourage the desired outcomes we determine for this review, for example:

	Structural	Target & penalty	Formal mechanism	Discretionary award
Safety		HASAWA and ESQCR compliance		
Environment			losses SF6 leakage visual amenity carbon emissions from operations	waste management
Customer Service		guaranteed standards	IIS resilience programmes providing connections	Priority Customer Care initiatives
Efficiency	opex competitive tendering[4] transmission reinforcement (exit charges)[5]		capex sliding scale	

The more radical roles for distribution discussed earlier require a more radical approach. We look forward to developing this with you.

Cost Assessment

Cost assessment must include the cost of capital and the building blocks thereof. Long-term funding for long-lived assets requires stability if it is to be genuinely efficient in the long-term, so we should not focus unduly on short-term rates in volatile debt markets. Neither should the legitimate costs associated with previous financing decisions, that were demonstrably efficient at the time they were made, be disregarded where the most efficient option is to leave that financing in place.

We agree that whole-life costing and capex/opex/performance trade-offs are key areas to develop, but first we need to establish a common language. We need both to establish a working definition of what (for example) whole-life costing means, and also to ensure that the base figures used are truly comparable. A preliminary review of the 2006/07 RRP return suggests that there remain significant differences in the way that these figures are provided.

It is also essential that we understand the capex/opex/performance trade-offs. For example, some companies have inherited legacies of high-reliability high-cost unit-protected systems; others have invested heavily more recently in OHL rebuild (some with covered conductor) and switchgear replacement with remote control. All these improve performance, but at a cost.

The DPCR 4 methodology will not illuminate those issues, as it takes each area separately. Asset-rich companies will tend to have past investment fully funded, including renewal and

[4] This is a second-order structural incentive. If the overall incentives to capital and revenue efficiency are right, they will encourage competitive tendering where it is economic

[5] This would be a second-order structural incentive. If we had a balanced package of the treatment of exit charges, distribution reinforcement and constraint management, we would make balanced and informed decisions on developing the network

reinforcement of existing systems, as capex modelling simply replicates existing network architectures. There was no recognition of anything but the cruder aspects of network architecture in setting IIS targets, so those licensees that have been more prudent in their investments will not be adequately funded to close the performance gap.

Looking forward, there will also be a need to recognise the influence of intended works during much-needed asset investment on:

- higher voltage primary systems on system security and, accordingly, the introduction of increased risk of interruption.; and
- lower voltage systems on pre-arranged interruptions.

The IIS benchmarks have largely been established in a period that did not contain as much system investment as the forthcoming period is expected to contain, and allowances must be made for planned outages and outage risk.

Similarly, while it is rarely efficient to (e.g.) change switchgear to reduce maintenance costs, those companies with younger populations would expect to have lower operating costs. Again, the DPCR 4 methodology takes these issues in isolation. There must be a reward for past capital efficiency, whether discrete or reflected in opex and performance targets.

There is also scope to expand the concept behind IFI, of protecting some activities from the full force of incentive regulation. Given the known skills shortages in the industry, and the need to incubate a team of highly-skilled engineers to transform networks, it may be appropriate to ring-fence areas such as network policy and the strategic planning element of network design and engineering.

Process

As noted earlier, we support the continued use of a five-year review period. We also agree that steps should be taken to reduce the discontinuity in investment that might arise at the boundary between such periods. We therefore welcome the extension of IFI and RPZ to 31st March 2010.

We also suggest setting, early in the DPCR 5 process, IIS targets and rewards for the period to 31st March 2010. This would benefit customers by providing clear signals for an investment stream driven entirely by incentives. The key parameter here is not the mid-point of the scheme. That figure, and any associated costs allowed to reach that figure, are part of the wider settlement.

The parameters that determine the extent of our QoS improvement investment programmes are the IIS reward rate and the sliding-scale capex efficiency retention rate. These determine the £/CI value at which we are prepared to invest, and these are the values that need to be set early to allow us to manage the transition of these programmes into DPCR 5.

The mid-point of the IIS is still an important value, and warrants a thorough review. While we agree with the philosophy behind the 20-year targets published at DPCR 4, it is essential that those targets are recalibrated at this review. We can more accurately take account of the underlying drivers of performance (e.g. through the Imperial College reference networks project) rather than simply roll forward existing targets based on less accurate data than is now available.

We accept that distributors should engage with stakeholders on options for their business plans. It is self-evident that this should be framed in a way that is meaningful to those stakeholders, as we have done before.

The key issue is that any consultation should also be meaningful to the review process. There is, for example, little merit in debating targets for distributed generation. Similarly, we should engage at a level consistent with the scale of the debate: giving presentations to each parish council is too much, but sending letters to the regional assemblies is too little.

We recognise the merits of allowing more time for us to prepare and submit our response to each consultation paper. However, the proposed timetable seems to us to create an unduly long gap between initial and final proposals. Clearly, there will be interaction between regulator and licensees in this period, and we note that a workshop is proposed for September 2009.

We submit that the interests of customers are best served by a robust and transparent process. Therefore, we suggest that the September 2009 checkpoint (currently proposed to be a workshop) include a formal quantified published statement on Ofgem's work to date. This need not be a full consultation paper, but should include a review of current thinking on the key issues. It seems to us that the bulk of this work will have had to be done to create a presentation that makes the workshop meaningful.

There was criticism at DPCR 1 that there was no public statement from Offer (as was) on progress in the review between initial and final proposals. We should take care to avoid repeating that mistake.

These issues can be mitigated, but not removed, by strengthening the January 2009 paper. Again, a significant period will have elapsed since the early 2008 initial consultation, which should allow sufficient time for Ofgem to develop its thinking on key parameters for the review. Further, Ofgem will have had both historical data and draft forecasts for around six months, in which time significant quantitative analysis could have been carried out.

Therefore, we suggest that a challenging front-end loaded timescale be set for the review, of:

construct radical long-term scenarios and carry out cost-benefit analyses of new roles and responsibilities for distributors	February 2008
issue FBPQ based upon costed roles and responsibilities	March 2008
submit historical data and draft FBPQ response	July 2008
issue consultation, laying out firm positions on key principles and quantified preliminary analysis of historical and draft forecast data, with indicative output measures & levels and associated income streams Issue initial proposals	January 2009
submit final FBPQ response	Easter 2009
issue consultation, with quantified analysis of historical and final forecast data, and updated quantified output measures & levels and associated income streams	July 2009
issue quantified statement on work to date	September 2009
issue final proposals	November 2009