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9 August 2007

Dear Martin

OFGEM CONSULTATION ON DPCR5 – LOOKING AHEAD

We are pleased to have the opportunity to respond to Ofgem's consultation and we confirm that this letter may be placed on Ofgem's website. Our detailed reply is attached, and our main points are summarised below.

We think that Ofgem has correctly identified the main high-level factors which are expected to impact on distribution businesses going forward. First and foremost among these factors are likely to be the government's Energy White Paper and the European Union's binding agreement to a 20 per cent renewable energy target. However, this is perhaps not the whole story, as alongside these policy developments we are also witnessing a rapidly growing public awareness of mankind's impact on the environment and the need for more sustainable ways of living that can maintain our planet's capabilities for future generations.

Awareness of these issues has moved dramatically in the last few years and could well change beyond all recognition by 2015 (the most likely end-year of the next price control period). So a significant challenge for the review will be to put DNOs on a path that both anticipates the direction in which society is now travelling and also contains sufficient flexibility to deal with expected developments while maintaining high levels of regulatory commitment.

Above all, DPCR5 will offer an important opportunity to put in place incentives for the distributors to adopt an holistic, long-term approach to infrastructure management which better recognises the significant social and environmental contribution that they can make to the communities they serve.

Our response sets out the main ways in which the DNO incentive package can be rebalanced to recognise the importance of the new context, particularly with regard to the DNO carbon footprint. We hope that Ofgem will work with us to build on these ideas, in order to create a framework where customers and other stakeholders in the year 2015 will look back at DPCR5 and recognise that it embodied the right choices.

We also believe that there are important areas where the price control process can be improved. In particular, more weight should be placed on the DNOs' investment forecasts, and DNOs should not be penalised for having forecasts different from those of Ofgem's consultants, who will have probably conducted only a very high-level analysis.

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Equally, there should not be ad hoc penalties (adjustments) whose scope and quantum are not known in advance, as this would undermine incentives and could be seen as a way of avoiding more formal statutory enforcement arrangements.

Lastly, we fully support Ofgem's intention to survey consumers. We continue to believe that a regulator charged with acting in the interests of consumers must regularly engage with them to find out what those interests are at a time when consumer understanding of and engagement with environmental and sustainability issues are rapidly developing.

If you have any questions about this response, please do not hesitate to call me on 01293 657846.

Yours sincerely

Paul Delamare

Head of Regulation and Compliance
EDF Energy Networks

Attachment

DPCR5 – Looking Ahead

Detailed Response from EDF Energy

1. Objectives for DPCR5

We agree with the high-level objectives that Ofgem has identified. However, it will also be important for the review to consider how competing objectives are to be balanced, for example with regard to reducing costs while maintaining sustainable electricity networks (the lowest cost option is often not necessarily the most sustainable solution).

We would expect the planned consumer survey to provide some input into this question, but, as we note in our covering letter, it will need to be borne in mind that customers' views are likely to develop significantly during the price control period, particularly with regard to environmental and sustainability issues.

We strongly support the continued use of incentive regulation and the ability of companies to outperform the regulatory cost of capital for efficiently delivering the outputs that customers value. As we highlight throughout this response, the incentive framework will need to adapt to changing priorities and, in particular, the new environmental context.

Investor confidence is, of course, essential for delivering the increasing levels of investment needed in the distribution networks, particularly in cases where the companies may be cash negative for sustained periods, or possibly where they require new injections of equity. As we note above, there will be a difficult balancing act for this price control review: how to boldly address environmental and sustainability issues, while at the same time maintaining an evolutionary approach to networks regulation that continues to provide a high degree of regulatory commitment.

2. Roles and Responsibilities of Distribution Businesses

Carbon Footprint

We agree that the general duties on the distribution network operators should include consideration of the environmental cost of carbon emissions. We believe that this would fit well with Ofgem's principal objective to protect the interests of both existing and future customers, and also with its more recent statutory duties in respect of sustainable development.

However, while it might be possible to interpret the words 'efficient' and 'economical' in the current statutory general duties of the DNOs as being capable of embracing the cost of carbon, a more explicit approach would be both clearer and indeed more commensurate with the importance of the climate change challenge.

We therefore believe that Ofgem should take the opportunity provided by forthcoming energy legislation to persuade the government to amend the section 9 duties in the Electricity Act 1989 so that the importance of carbon costs is clearer.

The best way of doing this would be to modify section 9 of the Act so that electricity distributors, in discharging their duties –

(a) to develop and maintain an efficient, co-ordinated and economical system of electricity distribution, and

(b) to facilitate competition in the generation and supply of electricity,

must have regard to the need to reduce emissions of greenhouse gases within the meaning of section 26 of the Climate Change and Sustainable Energy Act 2006.

We believe that Ofgem should go further than just asking the DNOs to assess their own carbon footprint and should consider developing a carbon footprint incentive. We can envisage a package of incentives aimed at encouraging the DNOs to reduce their carbon footprint over time.

Such a package should focus on the areas which are relatively easy to measure, such as these:

- Electrical losses optimisation
- Power factor management (by customers or on the DNO network)
- Connection of low carbon generation
- Own energy consumption (by offices and substations)
- Sulphur hexafluoride management, and
- Fossil fuel usage reduction (by vehicles, mobile generators, and plant).

Of course, this list does not represent the totality of a DNO's current carbon footprint. For example, it does not include the carbon emissions that result from the manufacture of electrical cables and plant. However, these aspects would be difficult to measure and are already mitigated to some extent by the continuation of a high-powered capex efficiency incentive.

We do not believe that we should wait for the review to commence in order to explore these ideas, and we recommend that Ofgem establish a working group with interested parties this year to consider how such a scheme might work. EDF Energy would contribute strongly to the work of such a group.

Facilitating Demand Side Participation

We recognise the potential benefits to all participants in the energy supply chain of wider demand-side participation, facilitated by energy management systems and/or electrical appliances that are responsive to price signalling.

We believe that participation at the all-important residential customer level could arise through a growing public awareness of mankind's impact on the environment and the need to develop more sustainable ways of living. While the speed, scope, and timing of such developments is currently uncertain, it is important that the potential for change is recognised in the review, particularly regarding how distributors respond – reactively in some areas, and proactively, through the provision of new services, in others.

It is feasible that incentives on customers, such as export reward for micro-generation, could equally be applied to demand-side restraint. Such incentives could act as a powerful catalyst for wide-scale customer participation in the energy market and could have a real impact, not only on overall energy consumption, but also in terms of improved system load factor (i.e. less peaky load profiles) and a consequently reduced need for 'out-of-merit' central generation.

To maximise the potential of a more demand/micro-generation responsive market, it is possible that a new commercial model will emerge wherein customers as a whole will present an increasing portfolio of micro-generation and 'intelligent' appliances, the outputs of which will be managed and summated in real time via 'Aggregators', using highly developed information communication technologies (ICT).

Aggregators could use these outputs to assemble 'bids' and 'offers' in much the same way as the outputs from conventional power stations and demand-side contracts, but using the distribution grid effectively as the transportation system.

The adoption of this 'Large Scale Virtual Power Plant' concept would have important implications for the way in which the DNOs would need to become actively involved in generation scheduling, curtailment, and constraint management, and to provide a distribution system balancing service.

For the DNOs, potential benefits might accrue in terms of improved network load factor, reduced network losses, and (assuming coincidence of system and local network peak demands) deferred network reinforcement. Further benefits might include more selective load management during emergency conditions, for example in respect of protecting vulnerable customers.

The emergence of this new commercial model will depend crucially on the rollout of some form of smart metering. While we do not currently expect any mandate to provide smart metering to fall on the DNOs, we can foresee an important facilitating role in DNOs providing power line carrier (PLC) based communication networks as part of the ICT infrastructure (though we note that nowhere has this happened in the context of a competitive market for metering).

Of course, any PLC-based solution would be most effective where it was the preferred choice of all energy suppliers operating within a particular locality, because this would minimise unit costs and facilitate customer transfer. But it is far from clear whether suppliers currently have consistent requirements in this area. In our view, without such clarity the widespread availability of PLC services is unlikely to emerge.

Ofgem established its policy for telecommunications services provided by the DNOs in October 2001. It would be useful for Ofgem to confirm its policy in the light of smart meters and any possible widespread demand from suppliers to use PLC.

Ownership Unbundling

We agree that the question of the enduring relationship between distributed generators, distribution companies, and transmission companies, and any associated structural developments, should be included in the review.

We are, of course, aware of the European debate regarding the ownership unbundling of transmission businesses. We continue to believe that the current British approach in respect of distribution businesses works well in our context, though it might need to be adjusted at some time in the future to reflect the growth of distributed generation. Ownership unbundling is not a legal requirement in the UK and therefore, unless this situation changes, it should remain a subject outside the proper scope of DPCR5.

3. Reducing Emphasis on Five Year Allowances Set by the Regulator

We agree that there is merit in retaining a five-year review cycle, provided that it is built on fundamental longer-run assumptions more appropriate to the long-lived nature of network assets and configurations. We therefore welcome Ofgem's proposed work on long-term electricity network scenarios, which we believe can inform the development of the incentive framework, particularly with regard to the connection of distributed generation and the development of active networks and smart-grids.

We also welcome the certainty provided by the extension of the Innovation Funding Incentive (IFI) and the proposed development of the quality of supply targets. Of course, we would expect any such targets to be supported by suitable funding arrangements put in place as part of the review.

We believe that all elements of the incentive framework should be assessed to see if there is merit in applying the above approach. We also propose (below) a funding incentive scheme for long-term skills development similar in structure to the IFI. Such an incentive would also benefit from being decoupled from the quinquennial price review cycle.

Better Integration of Capex and Opex Allowances

As Ofgem is aware, we have strongly supported development of the regulatory reporting pack (RRP), because we believe it is essential that the regulator is able to make robust decisions based on robust data. We firmly believe that such data have not been available at previous reviews, leading to significant levels of regulatory risk and error with regard to the assessment of cost allowances.

The RRP has delivered a step change in the quality of the cost information available to Ofgem. It is now possible to develop improved econometric models for the assessment of relative efficiency. So we are encouraged by Ofgem's statement that it is reviewing its approaches to the projection of future expenditure requirements, building upon the more robust information available from the cost reporting work.

We urge Ofgem to:

- Ensure that it has access to appropriately skilled persons (i.e. professional econometricians) to carry out the work;
- Commit to conducting a full consultation exercise – in public, so that academics and other expert parties can contribute – with the aim of developing improved econometric models using disaggregated RRP data where appropriate; and
- Continue to apply skilled resource to improve the quality of RRP data in the period leading up to the review, particularly with regard to any DNOs that have not yet sufficiently embedded the RRP rules into their respective accounting systems.

Less Emphasis on Allowances

We are very interested in Ofgem's suggestion that there may be ways of presenting the price control proposals which place less emphasis on allowances.

The need for change in this area is clear. The current arrangements contain a significant disconnect, in that Ofgem encourages the DNOs to adopt robust and accredited asset management arrangements, and yet relies heavily during price control reviews on opaque and relatively simplistic forecasts by consultants.

We would support a process which places more weight on companies' own forecasts while recognising the need to protect consumers from inefficient investment and/or incentive arrangements.

We would also support a more symmetrical consideration of opex and capex that would encourage companies to adopt a whole-life cost approach to investment optimisation, in lieu of the current arrangements which discourage efficient opex alternatives to capex investment.

Assurance of a highly developed asset stewardship capability must be a key factor in providing Ofgem with the confidence to place greater weight on companies' asset management plans. Fortunately, the newly developed Publicly Available Specification (PAS 55) now provides Ofgem with a robust benchmark against which to form a view of a DNO's asset management (and hence investment optimisation) capability.

4. Incentives – Potential Simplification and Sustainability

Simplification

We see no particular need to simplify the incentive framework. In fact, within EDF Energy we have found it beneficial to create clear and discrete delivery mechanisms for the various incentivised activities, such as those dealing with customer service, innovation, undergrounding, and quality of supply. We firmly believe that bundling incentives together for the sake of simplicity is unnecessary and would be detrimental to internal accountability: this would not, in our view, represent better regulation.

We must also say that if Ofgem proposes to use menu regulation as a tool for assessing capital expenditure (like the Information Quality Incentive used in the GDPCR) then the proposed structure of this must be communicated before companies submit their forecast expenditure plans.

Sustainability

The concept of sustainability clearly embraces a balance of objectives for improving the environment, managing the country's transition to a low carbon economy, protecting vulnerable customers and communities, promoting energy saving, and securing reliable sources of energy. We believe that all of these aspects should be part of a rebalanced incentive framework for DPCR5.

The significant focus of all the environmental aspects should be the carbon footprint incentive that we have proposed above, but other areas should be incentivised too. We highlight six of these below.

- Long-Term Skills Development

The age profile of DNO employees is just as much a product of historical cycles as the replacement of ageing physical assets. It therefore seems entirely appropriate for Ofgem to consider the issue within price control reviews.

Clearly, companies will face short-term costs in recruiting staff, and these should be part of regular operating cost allowances. However, responsible companies will also incur longer-term costs aimed at increasing the pool of skilled resources, but for which the payback can be relatively uncertain. A good example of this is EDF Energy's participation in the UK Power Academy, which is an engineering scholarship fund for students that would like to study electrical engineering.

Other related activities include improving sector attractiveness by working with schools and youth apprenticeships, working with government (mapping foreign qualifications onto the UK equivalents to facilitate the importation of skills), and developing training centres. These activities not only provide opportunities for young people, but also contribute to Great Britain having a sustainable energy networks sector.

We believe that the regulatory issues associated with long-term investment in skills have similarities with those successfully addressed by Ofgem in respect of research and development activities – in particular, the lack of incentives to incur additional operating costs on longer-term activities within the incentive framework. We therefore propose that Ofgem develop an Innovation Funding Incentive-type scheme where the companies are given an allowance on a 'use it or lose it' basis.

Such an approach would also ensure that those companies that invest in training are not disadvantaged in the DNO cost benchmarking analysis by comparison with those companies that do not.

- Protecting Vulnerable Customers/Community Involvement

While we support the retention of the Customer Reward Scheme, we believe that Ofgem should be cautious regarding any possible extension. We believe that the current scheme works well because it encourages focused and targeted responses to particular challenges. To substantially widen the scope of this scheme would risk diluting this focus. If Ofgem wishes to increase incentives for 'responsible' and 'sustainable' behaviours under DPCR5, this should be integrated into the main incentive framework.

- Funding for Undergrounding in AONBs

This funding mechanism allows us to make an important contribution to communities in our EPN and SPN areas. We think that it should be retained and extended in scope and scale. In particular, in the DPCR5 period we should be looking to build on the excellent relationships that we have established during the DPCR4 period.

- Incentives for Network Performance

Incentives bearing upon customer interruptions and minutes lost should continue. But the framework must recognise the natural law of diminishing returns that will apply to further quality of supply related investment initiatives. As the current KEMA report on distribution network design and performance criteria points out:

> "As opportunities for quick-wins in performance improvement diminish, the setting of appropriate cost-reflective targets will become an increasing challenge for the economic regulator" (top of page 50).

In particular, an even greater focus on 'worst-served customers' (those relatively small groups suffering significantly higher than average interruptions), although ethically attractive, is unlikely to deliver benefit/cost ratios comparable with investments aimed at maximising overall security and availability.

- Cable Oil Leakage in London

The risk of oil leakage remains a significant issue, particularly in London, which has the highest concentration of fluid-filled cables. The main focus of the review in this area should be on funding the capital costs of removing the highest risk cables.

- Provision of Energy Services

It has been suggested that the ongoing cost of suppliers' energy savings initiatives via the provision of energy services could be recovered by distributors, to avoid the need for customers to enter into longer term supply contracts. We would be open to discussing such possible arrangements as part of the review.

Price Control Adjustments

We have significant concerns about the potentially subjective and retrospective nature of the one-off adjustments to which Ofgem refers. These were not part of the DPCR4 proposals and effectively have been imposed by Ofgem without agreement. They therefore undermine incentives, increase regulatory risk, and should have no place in a regulatory framework developed according to better regulation principles.

We would also recommend that Ofgem should consider the legal basis for any policy of imposing negative adjustments, bearing in mind the statutory framework for financial penalties established by the Electricity Act. It is inappropriate to use price control reviews, outside the legal protections provided by that framework, to impose what are de facto financial penalties.

Connection Costs and Margins

Before turning to process issues, we think it is important to raise an issue of substance that is not addressed in Ofgem's document.

We strongly support the current GDPCR proposal to allow the GDNs to retain a margin on customer-funded connections work provided in circumstances where competition has developed. However, the provision of connections (in both gas and electricity) at no more than the cost incurred itself represents an inappropriate barrier to the development of competition in the first place, and seems, to us, inconsistent with Ofgem's principal objective. Ofgem should therefore have a policy of always allowing the retention of margins on contestable connections work in order to provide a level playing field and so encourage competitor entry.

We also think that there should be a more flexible approach to the recovery of connection-related indirect costs. DNOs have different levels of such costs depending on the volume and intensity of activity in their areas, particularly regarding the ratio of initial enquiries to connection projects which actually proceed. These factors were not recognised in the DPCR4 benchmarking assessments or in allowances for operating costs – thus putting companies like EDF Energy, whose three areas are characterised by higher than average levels of economic activity, at a distinct disadvantage.

We believe that a new approach is required that would keep the costs and revenues for contestable work (including the indirect costs) outside the scope of the main price control. This would also partly address the current distortion that arises because indirect costs that are included in connection charges are wholly credited to the RAV, whereas the accounting treatment of those costs splits them out between opex and the RAV

Putting these two issues together strongly suggests, to us, that it would be appropriate to create a contestable connections 'trading account' that is kept outside the main price control.

5. Process – Better Engagement with Consumers and Stakeholders, and Fewer Documents

Consumer Research

We are pleased that Ofgem intends to work with DNOs to carry out consumer research to inform DPCR5. We continue to believe that any regulator charged with protecting the interests of customers should regularly attempt to ascertain or confirm what those interests are, in spite of the technical difficulties involved in identifying what may be latent preferences for some customers.

We believe that it is important for DPCR5 to explore customers' preferences regarding low carbon and sustainability issues while bearing in mind how much such opinions could have changed by 2015. Equally, it will be important to take account of government policy in this area, which is perhaps currently ahead of public opinion.

Ofgem has already carried out deliberative research (entitled 'Stimulating World' – June 2007) into consumers' understanding of the relationship between energy consumption and the environment. This revealed significant shifts in views between the two work-shops, the first focussing on spontaneous perceptions and knowledge, and the second allowing for a more considered examination.

The potential for such changes suggests that particular care and expertise is likely to be needed to understand customers' willingness to pay in these areas.

Stakeholder Engagement

We are keen to explain our plans to stakeholders and, with Ofgem's help in establishing a process, we will work with our stakeholders to ensure that they understand the role expected of them.

Fewer Documents

We strongly oppose the withdrawal of the September Update document from the DPCR5 timetable. The loss of this document would in our view leave a considerable gap in the process, since it would be difficult to understand whether Ofgem had accepted further evidence and argument presented by the companies in the light of the initial proposals.

The September checkpoint is also useful to facilitate the identification and correction of errors – an important aspect of the review which should not be forgotten.

The proposed removal of the Update paper also seems to us to run counter to Ofgem's better regulation duties, particularly in respect of transparency.

In a similar vein, we believe that Ofgem must not leave its decision on the cost of capital until the final proposals (as it did at DPCR4 and is doing in the current GDPCR). Such an approach is neither appropriate for something so fundamental to the UK's networks businesses, nor consistent with the principles of better regulation (in particular, those relating to accountability, consistency, and transparency). As the recent judgment of the Competition Commission in the E.ON appeal has demonstrated, it is possible for a breach of the better regulation principles to translate directly into a more substantive breach of Ofgem's principal objective to protect consumer interests.

It seems likely that the changes in approach that Ofgem has signalled in its letter (e.g. on incentives and allowances) could impact on the risk profile of the DNOs, so it will be all the more important that consideration of the cost of capital should be organised to follow a parallel path and timescale.

Authority Committee

We welcome Ofgem's intention to continue to use an Authority Committee at key stages of the review. We believe that, particularly in the current and dynamic energy policy context, it is important that the Authority and the distribution companies develop a shared understanding of what customers care about and how their developing needs can be met though the price control incentive systems and funding arrangements.

6. Plans for 2007

We support the activities that Ofgem has referred to in its letter. In particular, we see merit in Ofgem discussing targets for customer interruptions and minutes lost for the years 2010/11 and 2011/12 early in the process.

As we have noted above, we also believe that Ofgem should commence work in 2007 on a carbon footprint reporting and incentive framework.

EDF Energy Networks Branch

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