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Dear Martin

DPCR5 – looking ahead

Thank you for the opportunity to respond to your letter of 17 May 2007. The letter raises a number of very important issues for ENA's electricity DNO members and I am pleased to respond to it on their behalf. I have concentrated on two particular areas; first, the future roles and responsibilities of electricity distribution businesses in the context of the new energy policy environment and secondly, the framework for the review itself. ENA would welcome early dialogue with Ofgem over the forthcoming months on both of these issues.

Roles and Responsibilities of Electricity Distribution Businesses

It is becoming increasingly clear that the environment in which the next distribution price control review (DPCR5) will be conducted will be very different from previous reviews. Fifteen years of an incentive based regulatory framework has delivered considerable benefits to electricity consumers in the form of lower prices and higher quality of service. Distribution businesses have achieved significant improvements in operating efficiency whilst providing comprehensive support to the competitive energy retail market. This period has also been characterised by a reduction in the scope of electricity distribution business activities as competition has been introduced into areas such as metering and connections which were previously the sole preserve of the network operator. The result has been leaner, fitter businesses concentrating on developing and maintaining an 'efficient, co-ordinated and economical' system of electricity distribution and facilitating competition in the supply and generation of electricity.

In view of the changes in the energy environment that are now taking place we should re-examine, ahead of the forthcoming price control review, whether this model remains appropriate to meet the new challenges ahead for the industry as well as the energy economy at large.

It is therefore encouraging that your letter acknowledges this, inviting respondents to identify where changes should be made not only to the way that future price reviews are conducted but also more widely to the roles, responsibilities and obligations of electricity distribution businesses in this new environment.

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The Government's Energy White Paper and the national policy objectives that flow from it will, as you point out, bring new challenges to the electricity distribution sector. Meeting these challenges is likely to require a significant change in the way networks are operated and in network architecture itself. It will also require a review of the current regulatory framework which must adapt to enable and encourage this development to take place where it is appropriate. In this context, we welcome Ofgem's commitment to taking a longer term perspective at future price reviews than it has to date and more particularly to its proposal to develop long term network scenarios to inform their price review deliberations. As you know we have responded separately to that particular consultation and look forward to attending the forthcoming Ofgem workshop on 17 August.

DPCR5 should be seen as the first step away from the traditional network price review; with less emphasis on doing the same things more efficiently and more on the transition towards a new operational and regulatory framework for electricity distributors. However, whilst this may involve profound changes in the way networks are operated as new generation is developed, it will not by itself deliver Government energy policy objectives.

Even in this scenario DNOs will largely remain at the periphery of overall market developments. This may not be appropriate in this new world. Energy networks should be fundamental to the successful delivery of UK energy policy objectives, not only because of their role in transporting energy to over 20m end users but also because unlike other players in the market place they have an enduring relationship to all premises in their area of operation. Also, because of their market position they are unique in being able to articulate a public interest role rather than be subject to the constraints of the competitive market. ENA therefore believes that consideration should now be given to re-defining (and possibly extending) the DNOs' roles and responsibilities in certain key areas of UK energy policy, for example in relation to distributed generation, smart metering, energy efficiency, demand management, Urgent Metering Services, revenue protection etc.

I realise that such an approach would run counter to the trends of the last fifteen years. But things have and will continue to change and there is an increasing recognition that in certain areas (particularly where social and environmental considerations are prominent) market failures may be best addressed by a managed solution operated by the DNOs acting as, in your words, 'a tool for intervening in other parts of the energy sector'.

Framework for the Review

ENA welcomes Ofgem's plan to adopt a 'lighter touch' to regulating the next review and the associated reductions in workload and timescales which this entails. However, in view of the likelihood that this review will be characterised by a number of new challenges which will need to be addressed, this will not be an easy task. Ofgem will need to provide clarity over the details and implications of this new approach so that it does not bring with it an increase in regulatory uncertainty. Investor confidence is essential for delivering the increased levels of investment needed in the distribution networks. Consequently, we would urge early dialogue with you well ahead of the start of DPCR5 to ensure we are all clear about both the framework Ofgem is planning to put in place and the associated process for conducting the review itself. In particular, ENA members are keen to help Ofgem develop its thinking so that we can ensure a smooth transition from the old to the new world.

ENA members have discussed the issues raised in your letter and identified a number of areas which could form the starting point for our future discussions.

- It would be useful if we could establish a vision for success, agreed between the major stakeholders that will set out the key priorities for the review. For example, how should we balance short term cost reductions against the need for a long term sustainable solution for networks? How can we preserve regulatory stability and consistency in this new environment?
- The incentive framework will need to adapt to the changing priorities and new context. We welcome Ofgem's continuing belief in the merits of an incentive based regulatory framework which leaves '...decisions with company management operating in a regulatory framework that enables better performing companies to earn higher returns'. We would also support the retention of the current set of incentives but are concerned that there is no dilution of them into some form of 'package of commitments with funding conditional on delivery'. What we are looking for is consistency of policy across different instruments with discrete incentives on companies to encourage appropriate behaviour. This could for example involve augmenting the current incentive for connecting distributed generation to include a mechanism to fund deep reinforcement and perhaps new incentives based on the findings of the forthcoming customer needs survey, companies' carbon footprint etc.
- Whilst we believe it is appropriate for Ofgem to continue to employ a five yearly review cycle, it is appropriate to extend the planning horizon significantly beyond five years in order to develop a longer term strategy for networks on key issues such as quality of supply, storm resilience, innovation, sector skills and distributed generation. In this context it will be important to understand how Ofgem intends to integrate the findings from the work on long term network scenarios into the DPCR5 process at an early stage.
- There is uncertainty over what is meant in the letter by the move away from allowances. Companies would be concerned if Ofgem wants to impose ex-post penalties for non-delivery or failure to achieve standards. Similarly, the proposal to 'seek better integration of opex and capex allowances and incentives' needs clarification.
- We welcome the suggestion that this price review should involve engagement with local stakeholders; however, such consultation will need to be complemented by a willingness on the part of Ofgem to allow companies to reflect local requirements in their final regulatory settlement.
- The letter is notable for its omission of any discussion both of financing and how Ofgem proposes to determine the cost of capital for the DNOs particularly in the light of a possibly changing DNO risk profile and volatile debt markets.

As far as the process and timetable for the review is concerned, we welcome the early publication of your plans but are concerned about the reduction in consultation papers from seven to four. We recognise that there is now greater consistency in company data supplied to Ofgem as a result of the work on the cost reporting framework. However given the large number of other issues to be resolved during the review it seems excessive to reduce the consultations so drastically; in particular we are unhappy that there is none planned in the five month period between the Initial and Final Proposals in June and November 2009.

DPCR5 will represent an important shift in emphasis away from short term operating cost reductions towards longer term issues associated with replacing and enhancing networks to meet the challenges presented by a changing energy policy environment. It is therefore encouraging that Ofgem, ahead of the review process

itself, has chosen to open the dialogue setting out its thoughts on the way it proposes to run the review and raising the issues that will need to be tackled by it. This will enable full consultation to take place with appropriate stakeholders. ENA and its members are keen to participate fully in these discussions and would urge Ofgem to set them up as soon as is practicable.

We therefore look forward to hearing from you in the very near future.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'N Goodall', with a horizontal line underneath.

Nick Goodall
Chief Executive