



SP Transmission & Distribution

Response to Ofgem Open Letter: DPCR5 - Looking Ahead

10th August 2007



EXECUTIVE SUMMARY

We are pleased to have this opportunity to provide our thoughts on the key issues for the forthcoming distribution price control review. DNOs have a central role to play in the delivery of energy policy objectives in both a European and UK context. Delivery of these objectives will require different behaviours from network companies together with a balanced, supportive and forward looking regulatory framework. The forthcoming price control review is therefore of fundamental importance to our energy future.

We welcome recognition from Ofgem of the unique context of the forthcoming price review and the need for the approach to network regulation to develop further to meet the many energy challenges. We are committed to working in partnership with Ofgem, government, the industry and all other stakeholders to meet these challenges.

Delivery of energy policy objectives is the key strategic issue for this review. Other issues, at a more detailed level, include:

- ensuring that electricity network companies are able to continue to attract investment against a background where successive price reviews have significantly increased the risk borne by DNOs;
- investing to preserve the safety and continuity of energy supplies and ensure that networks are sufficiently resilient to severe weather events;
- implementing a workable and balanced set of incentives aligned with energy policy objectives; and
- developing an effective and equitable framework that is in the interests of the end customer to support competition in connections.

Learning Lessons from Previous Reviews

It is important that lessons are learnt from previous price reviews and that those elements of the price control and regulatory framework that are inconsistent with energy policy objectives are addressed. We believe that there are a number of aspects of the current framework that fall into this category and require amendment including:



- the revenue driver mechanism linking allowed revenue to units distributed is not appropriate given the drive for energy efficiency;
- the losses incentive is flawed as it does not recognise the very limited ability of DNOs to influence the level of reported losses and therefore does not reward DNOs for actions taken to reduce losses; and
- the DG incentive does not contain a mechanism to fund the deep reinforcement required to facilitate generation in resource rich areas that are sparse in terms of infrastructure.

The open letter makes a number of positive suggestions as to how the regulatory framework might be improved. However, we have concerns around some of the suggestions relating to incentives and to the price review process.

Incentive Framework

We support Ofgem's view that the objectives of the DPCR will be best achieved by incentive regulation and would agree that incentive regulation has delivered sustained improvements in performance in a number of areas. However, we believe that some of the potential developments suggested in the Ofgem letter could weaken the effectiveness of the incentive framework. These include:

- an increase in scope/value of discretionary adjustments to revenue; and
- proposals for network performance targets being made in early 2008.

On the issue of discretionary adjustments to revenue, these are by nature subjective and a significant exposure to such adjustments would undermine the incentive properties of the price control regime. On network performance targets, this is one of the most significant incentives in the regulatory regime and, as such, must receive proper consideration during the price review process. This process should provide DNOs with sufficient opportunity to propose improvements to the methodology and to receive a fair hearing on any concerns with the current regime. We would welcome early dialogue on targets and on the associated regime. However, these should not be set until the full price control package is finalised.



Process

We believe that DPCR5 should contain a similar number of consultations and proposal documents as DPCR4. It is a fundamental part of a price review process that DNOs and other stakeholders receive clarity on Ofgem's proposals, are able to give them proper consideration and have sufficient opportunity to make representation on them as they develop. The aim of the process should be to ensure that there are no surprises.

The use of fewer consultations than at DPCR4 could undermine the price review process and increase the chances of the process being formally challenged by a DNO or another stakeholder. We would like to see a September update on Ofgem's proposals added to the timetable in line with DPCR4 and the recent TPCR. Given the time interval between the Initial Proposals (end June) and the Final Proposals (end November) together with the tendency for there to be significant developments between these proposals, we believe that it is in the interests of all stakeholders that a September update be provided. We note that Ofwat does not produce an interim document between its Draft and Final Determination. However, there is only three months between these documents and there does not tend to be the same amount of development between these as is the case in electricity.



1. MAIN RESPONSE

Objectives for DPCR5

- 1.1 The primary focus for DPCR5 must be facilitation of energy policy objectives. We are in general agreement with the position outlined on objectives for DPCR5 but believe there is a need for the regulatory framework to evolve and become more forward-looking.
- 1.2 We welcome Ofgem's recognition of the need not just to retain, but rather, to build further the confidence of investors and other stakeholders in the regulatory framework, in order to secure the increased investment that will be required. In this context we are concerned about downward signals in relation to cost of capital, for example in the recent Gas Distribution Price Reviews Initial Proposals May 2007. We believe that this is inappropriate when considered against a background where:
- successive price control reviews have significantly increased the risks faced by DNOs relative to other regulated sectors;
 - the cost of borrowing continues to increase; and
 - there are general inflationary pressures on world markets.

Roles and Responsibilities of DNOs

- 1.3 The roles and responsibilities of DNOs should be clearly defined and supported by an effective incentive regime. In our view, discussions around the future roles and responsibilities of DNOs should focus on facilitating energy policy. We do not consider that this will necessarily require major changes to the roles and obligations of DNOs. Rather the regulatory framework needs to encourage and enable DNOs to take the necessary actions.
- 1.4 Elements within the existing regime that require amendment in order to enable DNOs to fulfil this role include the losses incentive and the revenue driver mechanism. The DG incentive within the current regime requires less significant



amendment but should be supplemented by a mechanism that funds the deep infrastructure required in areas rich in renewable resource but sparse in network. In terms of additions to the current regime, then we believe that consideration should be given to a DNO driven investment programme on smart-metering both in customer's premises and at strategic points on the distribution network.

Assessing DNO Carbon Footprints

- 1.5 We believe that the regulatory framework should seek to promote actions and behaviours that reduce the environmental impact of DNO activities. We therefore see merit in considering the actions that DNOs are taking, either as standalone businesses or as part of a wider group, to reduce their carbon footprints. However, the initial focus of such an exercise should be on identifying best practice rather than on complex and onerous data requirements potentially coupled with some form of incentive regime.

Transmission/Distribution Interface

- 1.6 Another area touched upon in the open letter is the distribution and transmission interface. Issues around this interface have been discussed in detail in the TADG (Transmission Access for Distribution Generation) forum. TADG evaluated a number of potential models, some of which would require little or no change to the role of a DNO and others that could involve significant change. We believe that the arguments in support of significant change are weak and that there is no need for this issue to be addressed during DPCR5.

Compulsory Competitive Tendering

- 1.7 The possibility of compulsory competitive tendering is also raised in the open letter. We believe this could threaten the safety and integrity of the network and is fundamentally against the best interests of customers. We also believe that such an exercise would be onerous in terms of resource requirements and could result in a reduced focus on the real challenges for the review.



- 1.8 Lessons should be learned from the rail industry and on the detrimental impact that fragmentation of the industry, driven by the regulatory framework, had on the safety and integrity of the rail network. We believe that compulsory competitive tendering of DNO services could have a similar and detrimental impact on the distribution network because of loss of control and fragmentation of operations.
- 1.9 Aside from the potential consequences of compulsory competitive tendering, we see no benefits to customers given the strong efficiency incentives on DNOs, existing procurement legislation, the level of detailed information available via RRP and the comparative analysis carried out by Ofgem. DNOs are investor owned utilities and decisions on how services are procured and delivered should be left to management.

Unbundling

- 1.10 We do not believe that there is any need for compulsory ownership unbundling of distribution activities from generation and supply interests. The strict separation regime that has been in place since the late 1990's has, and continues to be, extremely effective. We see no merit or benefit to customers, generators or other stakeholders from compulsory ownership unbundling. We also note that the focus of European discussions is on transmission rather than distribution unbundling.

Reducing Emphasis on 5-year Allowances Set by the Regulator

- 1.11 We agree in principal with 5 yearly reviews and a building block approach to assess revenue requirements, however there is a need for the potential weaknesses of this regime, such as short-term focus and difficulties with benchmarking, to be recognised. Consequently, we support a move to a longer-term framework that would provide greater consistency and certainty over a more sustained period.



1.12 We do not agree with the suggestion that allowances do not determine what is actually spent by companies. The current regime provides a reduced return on expenditure in excess of allowances and it therefore follows that allowances do constrain what companies actually spend. Ofgem's duty to fund the functions of licensees is also an important point that must be considered when setting allowances.

1.13 There are lessons that can be learned from the TPCR in developing flexible revenue drivers and logging up mechanisms to deal with uncertainty. This would enable less reliance on fixed allowances and should provide flexibility to deal with credible scenarios in a number of areas.

Delivery Challenges

1.14 We are pleased that Ofgem has recognised the challenges faced by DNOs around availability of skilled resources and agree that it is reasonable for companies to have to explain how they will address these challenges to resource delivery of future plans. The price control regime has a key part to play in this respect by providing sufficient allowances to train and retain skilled staff and to procure materials and contract labour. We are now competing in a global marketplace for skills, materials and services. This is resulting in unprecedented increases in commodity prices and supplier/contract costs. This review must recognise this and make sufficient allowance for the upward pressure on costs that this is driving.

External Issues

1.15 There are a number of issues, which were not considered at DPCR4, but which are impacting current levels of expenditure and will require expenditure during DPCR5. These are:

- obligations placed on DNOs by The Electricity Safety, Quality and Continuity (Amendment) Regulations 2006 relating to overhead line clearance from trees and buildings; and



- the rollout of BT's '21st Century Network'.

1.16 Expenditure driven by such external factors will require to be assessed at this review.

Incentives

1.17 Successive price reviews have introduced new and revised incentives in a number of areas including quality of service, distributed generation and network losses. We believe that the current regime has generally had a positive impact. However, there are aspects of the regime that have had unintended consequences and/or are not consistent with energy policy objectives and which require amendment. In particular the network losses incentive and revenue driver mechanisms require amendment

1.18 We support a review of the package of incentives with the overall goal of simplification and to ensure that all of the incentives are relevant, proportionate and within the control of DNOs. Effective incentives must be simple, well defined, symmetrical and within the control of the DNO.

1.19 We believe that a move away from symmetrical incentives towards penalty regimes and discretionary rewards would significantly weaken the incentive properties of the price control. Comments on the various elements of the current regime are set out below.

Revenue Driver Mechanism

1.20 The revenue driver mechanism, linking revenue to units distributed is no longer appropriate given the drive for energy efficiency. This should be removed. We are pleased that Ofgem has recognised this issue.



Network Losses Incentive

1.21 DNOs can have minimal influence on the level of reported network losses. As such the current losses incentive is fundamentally flawed. Our experience during the current price control clearly demonstrates that the factors which have the most significant impact on reported losses are:

- inaccuracies in settlement data reported by energy suppliers;
- levels of energy consumption; and
- levels of energy theft.

1.22 We believe that it is entirely appropriate that DNOs are encouraged to take action to reduce the level of network losses. The most pragmatic step that can be taken is the development of a regime where DNOs are funded to undertake specific programmes of work to reduce losses. These programmes could include network reconfiguration, reinforcement and the installation of low loss transformers.

Distributed Generation (DG) Incentive

1.23 There are positive aspects to the DG incentive introduced at DPCR4. The incentive is effective in areas where there is an established distribution infrastructure but is not effective in areas that are sparse in existing infrastructure. The current regime needs to be augmented by a mechanism to fund deep infrastructure.

1.24 We acknowledge that it was not Ofgem's intention to fund deep infrastructure to facilitate DG but would reiterate our view that such a mechanism is required if we are to harness the rich renewable resources that are present in areas such as Scotland and Wales. This will not be an issue for all DNOs but it is very important, in the context of UK and EU renewables targets, that a solution is developed for areas where this is an issue.



1.25 The mechanism introduced during the recent Transmission Price Control Review to fund the assets required to connect renewables to the transmission system is a positive development and represents a change in approach from Ofgem. We believe that this is a model that can be extended to the distribution system. The following principles could apply to such a mechanism:

- agree baseline investment to deliver baseline MWs;
- revenue driver to deal with variations from the baseline in terms of MWs delivered; and
- incentives for capex efficiency.

Innovation Funding Incentive (IFI) and Registered Power Zones (RPZ)

1.26 We regard both of these incentives as very positive developments in the regulatory regime. We welcome Ofgem's commitment to retention of IFI and believe that RPZ should also be retained. Many of the technological developments that have been delivered with the assistance of IFI are nearing the implementation phase and will form part of capital investment programmes in DPCR5.

Quality of Service

1.27 The quality of service incentive regime has been very effective in driving performance to the point where the performance of GB distribution networks is world class. We believe that improvements to the current regime should be considered in the following areas:

- addressing the significant variation in CI and CML incentive rates between DNOs to create a more balanced and proportionate regime from the customer perspective; and
- ensuring equitable treatment of companies that are out-performing the CI benchmarks.



1.28 We fully accept the need to improve our performance relative to some other companies in terms of average duration of interruption and are implementing extensive plans to do this:

- installing levels of network automation in line with those companies in the upper quartile of performance;
- improved zonal working practices; and
- extensive use of GPS and other technologies to improve operational effectiveness.

Creating a Balanced and Proportionate Regime

1.29 There is a wide variation in the incentive rates, in terms of £m/CI and £m/CML, applicable to each DNO under the quality of service incentive regime (see table 1 below). This variation results in a significant inequality between customers in different parts of the country for a given interruption. This arises because the amount of revenue exposed to the incentive regime for each DNO is calculated as a percentage of allowed revenue without sufficient consideration of drivers of allowed revenue relative to differences in the customer base between DNOs.

1.30 We can illustrate this point by analysing the impact of an incident interrupting 500 customers for 60 minutes (see table 1 overleaf). The highest value per connected customer across all DNOs is more than ten times the lowest and there are significant variations between companies.

DNO	CI Rate (£m/CI)	CML Rate (£m/CML)	Incident Value (£k)	Impact per connected customer (pence)
SHEPD	0.08	0.11	10	1.45
WPD South West	0.1	0.17	9	0.88
SPM	0.18	0.22	11	0.73
SPD	0.23	0.3	10	0.53
LPN	0.3	0.34	11	0.50
NEDL	0.1	0.14	6	0.38
WPD South Wales	0.07	0.12	5	0.32
UU	0.18	0.23	7	0.29
YEDL	0.14	0.18	6	0.25
SEPD	0.18	0.26	6	0.21
CN West	0.15	0.2	5	0.21
SPN	0.09	0.14	4	0.17
CN East	0.11	0.15	4	0.17
EPN	0.16	0.25	4	0.13
Average	0.15	0.20	7.1	0.35

Table 1: Analysis of Impact of Incident Interrupting 500 Customers for 60 Minutes

1.31 We request that this issue is given appropriate consideration during DPCR5. In our opinion a more balanced and proportionate regime, in terms of value/cost to customers and impact on DNOs, should be introduced.

Treatment of Companies Out-performing CI Benchmark

1.32 We believe that SP Manweb, the frontier performing company in terms of customer interruptions (CI) at DPCR4 was disadvantaged relative to other companies in terms of scope for out-performance of its CI target and an extremely onerous customer minutes lost (CML) target. This had the effect of skewing the incentive towards a penalty regime for SP Manweb compared to a reward regime for DNOs with worse historic CI performance.

1.33 SP Manweb's unique interconnected network has historically delivered frontier CI performance to its customers. This ageing network requires higher levels of expenditure relative to more conventional networks to maintain performance at current levels. This is an issue that should be addressed at DPCR5.

1.34 In terms of CML, the targets for SP Manweb and four other DNO's that were out-performing the CI benchmark at DPCR4 were based on their own CI performance together with upper quartile interruption duration. However, those



companies that were under-performing relative to the benchmark had CML targets based on the benchmark together with upper quartile duration. As a result, the regime is more onerous for the DNOs that perform best in terms of CI. We believe that this anomaly should be addressed at DPCR5 and that the CML targets for all DNOs should be based on benchmark CI performance.

Setting DPCR5 Targets

1.35 We note the suggestion from Ofgem that proposals for CI/CML targets for the first 3-years of the next price control might be made in early 2008. The network performance incentive is the most significant in the current regime and, as such, must receive proper consideration during the price review process. While we would welcome early dialogue on targets and on the associated regime, targets should not be set until the full price control package is finalised.

1.36 The price review process must provide DNOs with sufficient opportunity to propose improvements to the methodology and to receive a fair hearing on any concerns with the current regime. In addition, it is not possible to consider network performance targets separately from other parts of the price control package such as investment, revenue allowances and the allowed cost of capital.

One-Off Revenue Adjustments and Discretionary Reward

1.37 We have previously referred to the benefits of a robust incentive regime based on well defined, transparent and symmetrical incentives. However, we believe that some of the developments suggested by Ofgem in terms of one-off revenue adjustments and discretionary rewards could undermine the incentive properties of the price control regime and create unnecessary and unreasonable levels of uncertainty/regulatory risk.

1.38 Any potential for revenue adjustments, positive or negative, together with the associated rules and circumstances in which they will be applied, must be clearly set out at the previous price control review. There must be no scope for subjective judgements by Ofgem to result in revenue adjustments.



1.39 Similarly, we are concerned at the suggestion that the scope and value of discretionary rewards might be extended. Such schemes by their very nature are subjective and we do not believe that an increase in scope/value would be consistent with the principles of better regulation.

Process – Better Engagement with Consumers and Stakeholders, Fewer Documents

1.40 We very much welcome the suggestion that this price review will involve more engagement with local stakeholders than has previously been the case. However, such engagement will need to be complimented by a will from Ofgem to incorporate local requirements into the regulatory settlement. We believe that previous price control reviews have not given sufficient consideration to local issues and the different needs of customers and other stakeholders in different locations. Examples from DPCR4 include:

- the absence of a mechanism to fund the infrastructure required to deliver the aspirations of the Welsh Assembly Government in relation to renewable generation; and
- little consideration of individual DNO proposals to address local quality of supply and environmental issues.

1.41 We are concerned at the suggestion that DPCR5 will involve fewer main consultation documents than previous reviews. It is a fundamental part of a price review process that DNOs and other stakeholders receive clarity on Ofgem's proposals, are able to give them proper consideration and have sufficient opportunity to make representation on them as they develop. The aim of the process should be to ensure that there are no surprises. In particular we are most concerned at the absence of a September update document from Ofgem's proposed timetable. This issue is dealt with in more detail in paragraph 1.48 in relation to the proposed timetable for the review.



- 1.42 In our view the number and frequency of the consultations and proposals papers was a significant contributor to a successful review from the perspective of all stakeholders. While we appreciate that this degree of consultation places a significant resource burden on Ofgem, we believe that it is an absolutely fundamental part of the process. The use of fewer consultations would significantly undermine the price review process and could increase the chances of the process being formally challenged by a DNO or another stakeholder.
- 1.43 We do not consider that there is a case to reduce the number of consultation documents. Indeed, Ofgem's own review of the DPCR4 process indicated very little support for a reduction in the number of consultation documents. We would ask that Ofgem reconsider this aspect of its proposed process and provide proper justification for any reduction in the number of consultation documents.
- 1.44 We note that there are more workshops planned for DPCR5. While we welcome more workshops, we do not believe that these can be used as a substitute for proposals documents and for detailed bilateral discussions between Ofgem and each DNO.

Transparency

- 1.45 It is very important that DNOs and other stakeholders are able to understand Ofgem's proposals and their potential impact. From a DNO perspective, it is particularly important to be able to understand the cost models that will be used by Ofgem and to be able to have an audit trail between proposals and cost submissions. We would therefore very much welcome involvement in the development of Ofgem's cost models and would request that these are finalised in advance of BPQ submissions. We believe that development of these models should take place during 2007 and early 2008.

Policy

- 1.46 We should endeavour, as far as possible, to resolve all policy issues in advance of initial proposals.



Timetable

1.47 Our main comments on the proposed timetable are:

- DPCR5 should incorporate the same number of consultations and proposals as DPCR4;
- in particular the September update document should be reinstated in the timetable;
- cost models should be developed as soon as possible and made available to stakeholders in advance of cost submissions; and
- we should endeavour to ensure, as far as is possible, that all policy issues are resolved in advance of publication of initial proposals.

1.48 We would like to see a September update on Ofgem's proposals added to the timetable in line with DPCR4 and the recent TPCR timetables. Given the time interval between the Initial Proposals (end June) and the Final Proposals (end November) together with the tendency for there to be significant developments between these proposals, we believe that it is in the interests of all stakeholders that a September update be provided. We note that Ofwat does not produce an interim document between its Draft and Final Determination. However, there is only three months between these documents and there does not tend to be the same amount of development between these as is the case in electricity.

1.49 We note the intention in the draft timetable for revised forecasts to be submitted by DNOs in March 2009. In our view this is too late in the process and does not provide sufficient opportunity for analysis and bilateral discussion in advance of initial proposals in June. This date should be revised to November 2008.

1.50 Experience from both DPCR4 and the recent TPCR has emphasised the need for work to begin as early on possible on the licence modifications necessary to implement the new price controls. We believe that drafting should commence once initial proposals are finalised and that a set of draft licence modifications should be published with the final proposals.



2. RESPONSE TO SPECIFIC QUESTIONS RAISED BY OFGEM

HAVE THE KEY STRATEGIC ISSUES BEEN CAPTURED?

2.1 The document captures some of the key strategic issues and correctly identifies the need for network regulation to develop to facilitate energy policy. We believe that the key issues are:

- cost of capital – and ensuring that companies can continue to attract the level of investment required to meet the many challenges faced by DNOs.
- level of investment – ensuring that sufficient funding is allowed to preserve the safety and continuity of energy supplies and ensure that networks are sufficiently resilient to severe weather events;
- incentives - implementing a workable and balanced set of incentives aligned with energy policy objectives; and
- competition in connections - developing an effective and equitable framework that is in the interests of the end customer.

2.2 The issue of incentives is covered separately in response to the specific question raised by Ofgem on this issue. The other issues are covered in more detail in the following text.

Cost of Capital

2.3 Successive price reviews have significantly increased the levels of risk borne by DNOs relative to other regulated sectors. The cost of capital must be sufficient to allow companies to attract and retain equity funding and must take proper account of the increased uncertainty and risk to returns from exposure to incentive regimes.

2.4 We have seen significant upward pressure on interest rates and inflation since the cost of capital was finalised for the transmission companies in December 2006. The TPCR cost of capital cannot be taken as the benchmark for DPCR5.



Levels of Allowed Investment

2.5 The last distribution price review recognised the need for increased investment allowances for DNOs. This represented the first stage of a long-term investment programme necessary to preserve the safety and integrity of the distribution network.

2.6 Increases in input prices during this period have had to be absorbed in allowances. Looking forward, these will drive continued increases in asset replacement allowances to address an asset base with an increasing average age. In addition future allowances must take account of the need to:

- improve the resilience of overhead line networks to increasingly severe and frequent weather events; and
- ensure that sufficient load related investment is allowed to cope with changes in the pattern of usage of demand and generation.

2.7 We do not agree with the suggestion that allowances do not determine what is actually spent by companies. The current regime provides a reduced return on expenditure in excess of allowances and it therefore follows that allowances do constrain what companies actually spend. Ofgem's duty to fund the functions of licensees is also an important point that must be considered when setting allowances.

Competition in Connections

2.8 We fully support the principle of competition in connections and have tried to lead the industry and work closely and constructively with Ofgem in developing the framework. A fair and effective framework is required that passes on the benefits of competition to the end customers.

2.9 The development of such a framework must be one of the key strategic issues addressed during this price review. Our DNO areas are experiencing the highest levels of competition in the country. Ofgem's most recent review of the



competitive connection market showed that 65% of the competitive connections in GB were completed in our DNO areas.

2.10 If not implemented correctly the current framework may not operate in the best interests of customers and could:

- result in a deterioration of service for the end customer;
- prevent effective competition; and
- allow any cost savings arising from competition to be retained by IDNOs and housing developers.

2.11 We believe that Ofgem's current policy of disallowing any profits earned by an affiliated connection business within a DNO area is discriminatory and prevents effective competition. We would urge Ofgem to reconsider this policy during the price review.

WHAT CHANGES SHOULD BE CONSIDERED TO THE ROLE AND RESPONSIBILITIES/OBLIGATIONS OF DISTRIBUTION BUSINESS?

2.12 The roles and responsibilities of DNOs should be clearly defined and supported by an effective incentive regime. In our view, discussions around the future roles and responsibilities of DNOS should focus on facilitating energy policy. We do not consider that this will require major changes to the roles and obligations of DNOs. Rather the regulatory framework needs to encourage and enable DNOs to take the necessary actions.

2.13 Elements within the existing regime that require significant amendment in order to enable DNOs to fulfil this role include the losses incentive and the revenue driver mechanism. The DG incentive within the current regime requires less significant amendment but should be supplemented by a mechanism that funds the deep infrastructure required in areas rich in renewable resource but sparse in network. In terms of additions to the current regime, then we believe that consideration should be given to a DNO driven investment programme on



smart-metering both in customer's premises and at strategic points on the distribution network.

HOW CAN WE BUILD ON OR MAKE BEST USE OF THE RANGE OF DEVELOPMENTS SET OUT IN PARAGRAPH 10 OF THE OPEN LETTER?

2.14 We support the development of a framework that has more focus on the longer-term and is designed to encourage and enable DNOs to facilitate energy policy and a sustainable energy system. As previously stated, the level of allowed expenditure will continue to be very important. Ofgem's duty to fund the functions of licensees is also an important point that must be considered when setting allowances. There are lessons that can be learned from the recent TPCR in developing flexible revenue drivers and logging up mechanisms to deal with uncertainty. This would enable less reliance on fixed allowances and should provide flexibility to deal with credible scenarios in a number of areas.

2.15 We welcome the work that Ofgem is proposing to carry out on long-term network scenarios and believe that this will be an important input to the price control review. We are committed to providing our full support to this important piece of work.

2.16 We support a review of historic approaches to projecting expenditure requirements. We believe that this work should be progressed as soon as possible in order that all stakeholders have clarity on the techniques and models that will be used in advance of cost submissions (historic and forecast).

HOW CAN WE SIMPLIFY AND REFOCUS THE INCENTIVE PACKAGE TO ADDRESS FUTURE REQUIREMENTS?

2.17 We believe that the current incentive regime has generally had a positive impact but would comment that there are aspects of the regime that have had unintended consequences and/or are not consistent with energy policy objectives and which require urgent amendment. In particular the network losses incentive and revenue driver mechanisms require urgent amendment.



2.18 The quality of supply incentive regime has been very effective in driving performance to the point where the performance of GB distribution networks is world class. Improvements to the current regime should be considered in the following areas:

- addressing the significant variation in CI and CML incentive rates between DNOs to create a more balanced and proportionate regime from the customer perspective; and
- ensuring equitable treatment of frontier performers.

2.19 We support a review of the package of incentives with the overall goal of simplification and to ensure that all of the incentives are relevant and within the control of DNOs. Effective incentives must be simple, well defined and symmetrical. We believe that a move away from symmetrical incentives towards penalty regimes and discretionary rewards would significantly weaken the incentive properties of the price controls.

2.20 We also support the introduction of an incentive around SF₆ leakage, similar to that introduced at the TPCR, as part of DPCR5.

DO YOU AGREE WITH THE SUGGESTED PROCESS AND TIMETABLE SET OUT, BOTH FOR THE WORK IN 2007 AND FOR THE REVIEW? WHAT SHOULD WE DO DIFFERENTLY?

2.21 We do not agree with the suggested process and believe that the proposal to reduce the number of consultation documents from DPCR4 will undermine the process. It is a fundamental part of a price review process that DNOs and other stakeholders receive clarity on Ofgem's proposals, are able to give them proper consideration and have sufficient opportunity to make representation on them as they develop. We believe that the timetable as proposed by Ofgem does provide this opportunity. In particular, we would request that a September update document be reinstated in the timetable.



- 2.22 We note the intention in the draft timetable for revised forecasts to be submitted by DNOs in March 2009. We believe that this is too late in the process and does not provide sufficient opportunity for analysis and bilateral discussion in advance of initial proposals in June. This date should be revised to November 2008.
- 2.23 Experience from both DPCR4 and the recent TPCR has emphasised the need for work to begin as early on possible on the licence modifications necessary to implement the new price controls. We believe that drafting should commence once initial proposals are finalised and that a set of draft licence modifications should be published with the final proposals.