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Dear Martin,

DPCR5 – Looking Ahead

SSE welcomes Ofgem's open approach to the development of the framework for DPCR5 and the opportunity to comment on the key issues and general approach for the review.

We agree that the current RPI-x framework has delivered significant benefits for customers in terms of lower prices and quality of supply. Our view is that continued evolution of this regulatory approach will provide ongoing stability for the market. This stability is crucial if companies are to successfully deliver the major investment required to replace ageing infrastructure and to meet the requirements for connecting new forms of generation which are key in helping to implement the Government's energy and sustainability policy objectives.

Key Strategic Issues

As well as encouraging a pro-investment climate, it is in our view vital that companies are able to achieve a sufficient return to be able to attract equity to fund the required investment. We believe that the continued evolution of the current RPI-x framework, with an appropriate cost of capital and associated incentives mechanisms will create the necessary environment for continued investment.

We therefore continue to support the use of a five year price control period with an emphasis on longer term planning. We also support the integration of long term thinking into DPCR5 wherever possible with incentives provided for the development of networks envisaged by long term scenario planning. As stated in our response to Ofgem's Long Term Scenario Planning consultation, there are likely to be a number of new key drivers, borne out of increasing safety and environmental pressures which should be factored into scenario planning. In our view, the outputs from the long term scenario planning work should be fed into the DPCR5 consultation process and we would welcome further clarity from Ofgem on how these two work streams will be integrated.

The Energy White Paper and government energy policy which will flow from it will clearly have a significant impact on the DPCR5 framework. Network companies are in an excellent position to help deliver government's energy and sustainability policies. The most obvious example of this is smart metering, where we believe a quicker, more cost-effective mass market roll-out could be achieved by the central involvement of network companies. Another important area is distributed generation where we agree that it will be necessary for the review to carefully consider the potential impacts which new forms of generation could have on the networks and the appropriate policy response. In this regard, it will clearly be vital to ensure that companies have appropriate incentives to connect new forms of generation in a timely fashion. We therefore look forward to Ofgem and DBERR's review of the barriers to the industry for distributed generation.

We agree that the review should consider mechanisms to reduce the environmental impact of distribution operations, particularly in relation to carbon. We would therefore welcome further discussion about how the correct incentives can be put in place for companies to deliver ongoing reductions to their carbon emissions.

Ofgem also discuss industry structures. We do not see any need to fundamentally review industry structures or relationships and indeed this might cut across the need to ensure a pro-investment climate. In particular, the question of effective unbundling of distribution has been considered by the European Commission and its advisers as part of the proposed third package of legislation to ensure effective competition in Europe. For example, the European Parliament's report to the Commission by Vidal-Quadras calls for further measures for effective unbundling (an Independent System Operator (ISO) or ownership unbundling (OU)) but that this should only apply to transmission networks.

Furthermore, the European Regulators Group for Electricity and Gas (EREG) in its advice to the Commission on further unbundling measures recommends OU for transmission but concludes that OU or ISO is not justified at the Distribution level. The report states that "The provisions described in directives 2003/54/EC and 2003/55/EC, clarified and reinforced by a new Regulation and/or Guidelines for Good Practice stipulating a detailed legal framework with strong control by regulators, might be the best way forward for the distribution grids." The UK

has the most detailed regulatory framework in Europe coupled with strong regulatory control and there can therefore be no justification for further unbundling of distribution in GB.

Finally on roles and responsibilities, we note the point about enhancing competitive testing of services. These are already in place obligations on DNOs in relation to, for example, procurement. Furthermore, we consider that the use of appropriate incentives and benchmarking of relative costs is a more efficient mechanism for regulating DNOs than more prescriptive rules governing the way DNOs should run their businesses.

The Regulatory Approach and Incentives Mechanisms

We agree that appropriate incentives should remain central to the price control framework. In this regard, we believe that the current broad structure remains appropriate with 5 year rolling incentives for cost reduction, an IQI incentive for long-term stewardship and forecasting, IFI to address innovation and a quality of supply mechanism. We agree that it will be necessary to review the detail of these mechanisms to ensure that they continue to incentivise the correct outcomes. We also agree that it will be necessary to consider whether additional incentives will be required for example in relation to specific energy policy objectives.

We are however concerned about a couple of suggestions in Ofgem's consultation letter. In particular, we firmly believe that there should be no weakening of the current opex and capex incentives. The current set of incentive measures with their inherent long term focus have served the industry well to date and we see no reason to weaken or combine these to form packages of incentive measures as Ofgem suggests at paragraph 12.

We are also unclear as to Ofgem's proposals relating to an apparent shift in focus away from allowances (at paragraph 10). We would regard it as unacceptable for Ofgem to impose ex-post penalties for non-delivery or failure to achieve unspecified policy objectives. In general, ex-post rewards or penalties for performance which have not been specified in advance do little to incentivise the appropriate policy outcomes, but might create arbitrary winners or losers. We therefore do not believe that Ofgem's proposal (at paragraph 14) for one-off adjustments to revenue (positive or negative) as part of the price control review is a positive form of incentive since it does not provide the clear signals in advance which companies need in order to deliver desired outcomes.

We believe that there is some merit in the current narrow discretionary award approach for social issues (at paragraph 15) and suggest that it is sensible to maintain this form of incentive until the end of this price control period. However, at this stage we are not convinced that a discretionary award framework remains an effective means by which to incentivise companies in the context of wider operational performance.

In addition, we would add a number of other areas that we believe Ofgem should consider as part of the review.

- We believe that the volume driver has become unpredictable in recent years and is increasingly at-odds with environmental objectives. As a consequence, it should in our view be switched off. However, we believe that there remains a need for some flexibility in revenue forecasting and hence we suggest that consideration should be given to retaining a link between allowed revenue and customer numbers.
- Ofgem have rightly highlighted the need to incentivise connection of greater volumes of distributed generation. However, we continue to believe that forward-looking marginal cost models for determining transmission and distribution use of system charges is a major barrier to the deployment of renewable technologies. For example, in relation to TNUoS charges, for which embedded generators with a BEGA (Bilateral Embedded Generator Agreement) with NGET are also liable, we are concerned that these charges are not cost-reflective and are becoming an increasing barrier to entry to new generators, particularly renewables. We believe that a thorough review of the "first principles" of the TNUoS charging methodology is required with a view to developing a clear and transparent methodology that is fit for the challenges that face the GB transmission network. We continue to believe that Ofgem's proposals for a similar methodology in distribution will lead to similar problems and therefore consider that those plans too ought to be subject to a fundamental re-think.
- In terms of the development of competition in connections, it is important that network companies are able to make a margin in what is now an established market fully open to competition. This was the position as we understood it at the start of DPCR4 and we consider that the revised approach could undermine the competitive market. As a consequence, we would urge Ofgem to reconsider its position on this issue.
- We consider that the potential uncapped liability to GS payments should a major event befall a DNO need to be re-examined.

Process

We support Ofgem's proposals (at paragraph 16 and 17) for greater engagement with all stakeholders both by Ofgem and network companies and for the outputs from stakeholder consultations to be fed into the business planning process. We also support the use of an Authority committee at key stages of the process.

However, we are concerned that there is no consultation planned between initial and final proposals (June and September 2009). We believe that there is a need for some form of iterative consultation, be it public or private, between these two milestones.

Plans for 2007

The possibility of setting targets for 2010/11 and 2011/12 in early 2008 (as set out at paragraph 23) is worthy of consideration, but we are concerned that quality of service targets are fundamentally associated with incentive rates and investment. Therefore, if quality of service targets are to be rolled forward beyond 2010 some consideration will need to be given to addressing the mismatch with the timetable for determining incentive rates and capex.

I hope you find these comments helpful and look forward to further discussion with you over the coming months.

Yours sincerely

Rob McDonald

Director of Regulation