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Dear Rachel

Electricity Distribution Price Control Review – Policy Paper

Thank you for the opportunity to respond to Ofgem's DPCR5 Policy Consultation. The document raises a number of important issues for ENA's electricity DNO members and I am pleased to respond on their behalf.

Introduction and Background

In ENA's response to Ofgem's Initial Consultation in June we highlighted the three key issues for members as

- developments in the overall energy market environment which set the context for the review;
- the future roles and responsibilities of electricity distribution businesses within this new environment;
- the framework for the review itself.

Since June there have been fundamental changes not only in world energy markets but also the global economy which are likely to have a major impact on the UK over the next few years and hence upon this review. In particular the economic downturn and the great uncertainty in the financial markets will provide significant challenges for the financing of the companies at a time when their strategic investments will be a key component of the Government's energy policy. As the paper acknowledges, the economic downturn will also impact on a number of the input assumptions of the price control including load growth, connections demand, wage rates and material costs. Developing the appropriate regulatory framework within this new and volatile environment will be vitally important and we believe that we should not delay in jointly addressing these challenges at the earliest opportunity.

It is also very clear that since June the Government's commitment to a low carbon future has been reinforced by the passing in 2008 of the Energy Act, Climate Change Act and the Planning Act. We therefore welcome Ofgem's greater emphasis in the current paper on the environmental challenges that need to be addressed by the industry over the period to 2020. In our June response we expressed concern that these discussions risked being conducted in a long term vacuum, particularly as a result of the delay in publishing the output from the LENS process and integrating it into the current review. Whilst this has been remedied to some extent by the publication of the LENS work there remains an impression that this work is somehow

proceeding in parallel with the conventional review process rather than being integrated within it. Work is continuing on efficiency analysis, specification of outputs to underpin investment plans and measures to better incentivise companies to submit realistic capex plans. Elsewhere in the document DNOs are being encouraged to 'future proof' their networks, become highly innovative, increase their contact with key customers and stakeholders and break free from the shackles previously imposed upon them by rigid business separation rules and tight RPI-X regulation.

Ofgem should therefore seek to integrate these two areas of work, and ensure that there is an appropriate balance between the shorter term priorities associated with the conventional RPI-X model and the longer term requirement to adapt the networks to accommodate a low carbon economy. We believe that this will be best achieved via early discussions between the companies, Government and Ofgem to agree for the future a wider set of strategic priorities which align with Government energy policy goals.

DNO Roles and Responsibilities

DNOs are actively looking at how future changes in energy policy will impact their networks and are already engaging in the debate about what this might mean for their own span of operations. As we emphasised in June, DNOs are very supportive of an expanded role and are ready and willing to take up the challenges presented, including working with generators and customers on demand-side issues including energy efficiency, zero carbon homes, 'experimenting with new commercial arrangements', supporting the roll out of smart metering or developing innovative solutions to accommodate the new forms of generation connecting to the networks. However, for this vision to become a reality will require clarity on the DNOs' roles and responsibilities in this new environment; it will also require a supportive and coherent regulatory framework which explicitly recognises the new activities being undertaken by the DNOs, the extra resources that will be required and the increase in risk that DNOs will have to bear.

Dealing with Uncertainty

A key requirement of any regulatory framework is to ensure that the confidence of the financial community is retained, even during difficult economic circumstances. Over the DPCR5 period DNOs will need to further increase their capex if they are to fulfil the needs of their stakeholders for a high quality of service, long term supply security and a low carbon economy. This will require the provision of significant amounts of finance from the investment community. If current circumstances persist this will mean higher financing costs and more restrictive debt covenants. Prospective investors must therefore be re-assured that all efficient expenditure by the DNOs is recoverable and that the rewards available to them are commensurate with the risks they are facing in transforming their networks.

A consequence of this will be the need for mechanisms within the price control that deal with the inherent uncertainty that will characterise the DPCR control period. In particular, for those risks over which DNOs have little control such as changes in obligations, then the regulatory framework must ensure that the risks are apportioned fairly between customers and the DNOs.

In June, we expressed our concern with the suggestion that the regulatory regime was becoming too complex and needed to be simplified. We therefore welcome the confirmation in the paper of Ofgem's commitment to a continuation of an incentive based regulatory framework and the retention of most of the current mechanisms. The incentive mechanisms are well understood within the industry and experience shows that they work well to modify behaviour. However, Ofgem must be careful when reviewing the current suite of incentives (and, indeed, when considering new

incentives) to get the right balance between the power of each incentive and the associated risk exposure inherent in each.

Scope for Further Efficiencies

We recognise that a strong incentive based regime will continue to be necessary to drive the search for greater efficiency. However, it would be wrong for Ofgem to assume that DNOs can continue to out-perform the rest of the UK economy by achieving real unit operating cost reductions, as they have done since 1990. The current levels of opex spend against the DPCR4 allowances clearly point to the increased difficulty in achieving further efficiency savings; in addition it must be recognised that any increase in the DNOs' role and responsibilities to help facilitate the move to a low carbon economy will require a renewal of skilled resources that have been eroded by the focus on cost reduction since privatisation. Asserting the need for further reductions at a time when DNOs should be gearing up for significant change would therefore be counter-productive.

Smart Metering

The paper acknowledges that as a result of the proposed roll-out of smart metering from 2010 some of the gas and electricity meters currently installed as a result of a Licence obligation on the network operator may be replaced by a smart meter before the cost of the asset has been fully amortised. However, we are concerned that the Policy paper questions whether in this situation any compensation is either 'appropriate or necessary'. It is difficult to reconcile this statement with the assertion in Para 1.62 of the document that one of the guiding principles of Ofgem's RPI-X@20 Project is that there will be no stranding of efficient investment undertaken by network companies. In December 2008 we wrote to Emma Kelso and yourself requesting clarification on this point and are disappointed that we have yet to receive a response.

Another important aspect associated with the proposed roll-out of smart metering from 2010 is the effect that it will have on the accuracy and volatility of the data from the settlements system, particularly during the ten year transitional period, 2010-2020. Any increase, for example, in the power of the losses incentive needs to be considered in this light.

Losses Incentive

Ofgem's proposal to tighten the losses target and increase the incentive rate could impose significant financial risks on the companies over which they have only limited control. We believe therefore that the proposed losses incentive mechanism needs to be modified and replaced by a quasi output mechanism. We have discussed the benefits of the proposed scheme at Ofgem's environmental issues working group and suggested reasons why the sole use of settlement data to incentivise companies to manage losses is flawed because this does not measure technical losses and is not controllable by DNOs. ENA members continue to believe that technical losses should be incentivised via an input mechanism and non technical losses should be incentivised via an output measure to ensure that the improvements in data quality from DPCR4 are maintained.

Distributed Generation

We welcome Ofgem's recognition that the primary factor inhibiting the growth of distributed generation is not the behaviour of the DNOs but, as we have pointed out on many occasions, the difficulties in obtaining planning permission for its development.

We believe that the structure of the Distributed Generation incentive mechanism, which effectively acts as a funding vehicle for efficient generation connections, is

broadly appropriate and should be maintained in DPCR5. However, in addition to strengthening the value of the incentive, there are a number of improvements which should be incorporated. These include the movement to a single charging pot and ensuring that the mechanism is sufficiently flexible for future requirements should there be a significant increase in DG connections beyond current forecasts, e.g. should a feed in tariff be introduced. The DNOs are however concerned that the proposal to compensate pre-2005 connected DG will be very difficult and costly to administer.

Financial Issues

ENA members are, in terms of method, supportive of maintaining the traditional approach to determining the cost of capital. However, we are in unprecedented times and believe if the market conditions do not settle down prior to Ofgem making its decision on the cost of capital there is a real risk that, if too much emphasis is placed on long term trends, it will be set at too low a level. This will be just at the time when many DNOs will have to raise more finance to deal with increasing investment levels.

Also given the likely continuing uncertainty surrounding data used in the cost of capital calculations linked to the current economic conditions we believe it would be appropriate to use the Dividend Growth model as a cross-check against the proposed cost of capital.

We are currently undertaking work to assess the impact on the cost of debt and the long term cost of equity of the current financial conditions. We aim to share the results of this work with Ofgem prior to the development of policies to go into the Initial Proposals document.

(i) Financeability

In assessing the financeability of the price control proposals Ofgem must ensure that the assumptions it uses to estimate the cost of capital are the same as those used in its financial models. This is particularly important for DPCR5 because one impact of the credit crunch has been to introduce large premiums for paper lower than A3/A-.

We understand that credit/default spreads are wider than has been the case in previous recessions, indicating the unprecedented nature of the current environment and the prospect of significant levels of corporate defaults to come. It seems likely that these will persist for some time, at least throughout 2009, and may lead to a more fundamental re-pricing of default risk (there being little price discrimination for risk during the "bubble"). Setting the price control on the basis of BBB assumptions would pose an unacceptable level of risk to DNOs in the current conditions.

Furthermore, in assessing financeability Ofgem has been able to improve a DNO's position through assuming a proportion of index-linked debt. In DPCR5 Ofgem will need to make realistic assumptions about the availability of index linked debt. Currently, following the demise of monoline insurance as a form of credit enhancement, the market for index linked debt has all but dried up. Evidence of an enduring recovery will be needed before Ofgem can make assumptions about future use by the DNOs.

Ofgem should take a cautious approach to assuming new equity finance, either through rights issues or through retained earnings. In particular, we believe that it would be unwise to make significant changes to regulatory depreciation assumptions without being certain that the value of existing equity is not being diluted.

(ii) Pension Costs

We believe the best option for treating pension costs is to base the allowances on the DNOs' best estimates of the costs they will incur during the DPCR5 process. These estimates should be supported by the DNOs' professional pension advisers. We believe the pass through mechanism introduced at DPCR4 for efficiently incurred pension costs should continue through the DPCR5 period.

We also believe the option of using the latest available triennial valuations on the basis this would reduce the cost to customers in the short term, with there being a true up in DPCR6, is not a valid alternative as all the evidence points to this leading to significant underfunding of the DNOs properly incurred costs in the DPCR5 period. The option of having a re-opener when a new regular full triennial valuation is published which results in a material change to pension costs would protect DNOs from significant increases in their costs but would potentially cause a sharp increase in charges at the point the re-opener was settled.

Process and Timetable

We remain broadly supportive of the process and timetable proposed by Ofgem. The need for a published set of update proposals in September 2009 will be determined by the materiality of the likely changes being considered from July's Initial Proposals. If this proves to be so, it would be appropriate for shareholders to have confirmation of these changes prior to the publication of the final proposals.

The large amount of work that still needs to be done to translate the Ofgem's policy aspirations into a coherent price control settlement will require continued joint working with the industry. We would therefore strongly support the continuation of the current working groups and the re-establishment of the higher level Policy Working Group at the earliest opportunity.

ENA recognises that we are in a period of substantial economic and financial uncertainty at least as far as the setting of price controls is concerned and that this uncertainty is compounded by the need for network businesses to adapt quickly in order to help deliver Government environmental and energy policy. This background requires that DPCR5 delivers a price control which will require flexibility on the part of both Ofgem and the companies. We therefore look forward to continuing to work closely with your team to address the many policy issues raised in the paper.

I hope you find these comments useful.

Yours sincerely



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Director of Policy and Regulation