Scottish and Southern Energy

Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Rachel Fletcher
Director, Distribution
OFGEM
9 Millbank
London
SW1P 3GE

Telephone: 01738 456571
Facsimile: 01738 456415
malcolm.burns@scottish-southern.co.uk

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Dear Rachel,

Electricity Distribution Price Control Review: Policy Paper

Scottish and Southern Energy plc (SSE) welcomes the opportunity to respond to Ofgem's policy paper. We have attached, as an appendix to this letter, our detailed response to the specific questions raised in Ofgem's paper, plus supporting material in the form of further appendices.

Whilst we were broadly supportive of the objectives and themes highlighted in the initial consultation document, we are concerned that the policy paper is proposing changes that could effectively bring rate base regulation into GB regulatory markets at the expense of the tried and tested RPI-X incentive based regulation. Our main concerns are around the proposal to equalise the incentives on capex and opex, and the move to using return on regulatory equity (RoRE) to assess Distribution Network Operators' (DNOs') forecast levels of returns.

With regard to the former, we firmly believe that equalising the incentives on capex and opex will have adverse unintended consequences. In our view, the current driver to ensure that DNOs invest efficiently in their networks is key and must be retained to ensure the future health of the network. Any change that weakens the capex incentive will have an adverse impact on efficient network investment at a time when all DNOs have indicated a need to significantly increase such investment. This will drive most DNOs away from investing in the network for anything but statutory requirements. Moreover, we do not believe that adjusting these incentives to promote opex-based investment will have the desired effect. Strengthening existing incentives such as distributed generation (DG), along with maintaining the innovation funding incentive (IFI) and development of the proposed new innovation incentive will strongly encourage DNOs to seek opex solutions when and where appropriate. We consider that these reforms should be pursued rather than wholesale reform of the price control framework.

With regard to RoRE, we simply cannot see how the use of such a measure to identify a ‘notional band’ of returns within which all DNOs should fall will improve upon the well-defined regulatory standard of return on Regulatory Asset Value (RAV). Rather than cause any positive change in behaviour, this will cause confusion across the market (including stakeholders and city analysts).

Notwithstanding our concerns noted above, we recognise that we are in a period of substantial uncertainty, both in terms of the global economy and the level of change required within the network businesses to help deliver Government environmental policy. With regard to the latter, and as noted in our response to the initial consultation document, the priority must be on incentivising DNOs to tackle climate change.

We believe that this can best be done by retaining RPI-X incentive based regulation, albeit modifying it slightly to accommodate a few necessary improvements. These changes include a new innovation incentive under the environment theme, development of an advocacy based customer service measure under the customer theme and DNO specific output measures under the networks theme.

With regard to the environment, we are encouraged by Ofgem’s proposal to introduce an innovation incentive as a long term replacement to the Regional Power Zone (RPZ) mechanism. Key to this new incentive’s success will be whether it is sufficiently flexible to drive innovation over the five-year period, i.e. able to accommodate new technologies (or changes in behaviour) as and when they develop. Importantly, if DNOs are to invest in innovation, we believe there needs to be a very different approach to the allocation of downside risk than at present. We therefore support an *ex ante* funding approach for the new innovation incentive, based upon a clearly defined risk / reward mechanism that eliminates the need for case-by-case project approval from Ofgem. Consistent with appropriate risk allocation, we believe an asymmetric incentive is needed. Further opportunities to incentivise could include a discretionary reward-type approach whereby Ofgem could, at the end of the price control, reward particular examples of best practice.

On losses, we believe the retention of the current output measure and, in particular, its five-year rolling element, is key. We believe this latter aspect of the incentive will ensure that the improvements made during the current price control period are retained, and will erode any returns due to unsustainable improvements in losses. This should address Ofgem’s concerns regarding the level of returns that have been made by some other DNOs under the incentive to date.

With regard to DG, if Ofgem is committed to incentivising the DNOs to change their behaviour, we believe it needs to strengthen the existing DG incentive. Whilst we believe the current structure is broadly correct, it has not actively driven DNOs to connect DG onto the network, which will become more expensive as spare capacity declines. A stronger incentive to connect will therefore be required if Ofgem is committed to changing DNOs’ behaviour.

Also on DG, we are fundamentally opposed to Ofgem’s proposals to bring long-standing existing DG within the charging base for distribution use of system charges. We believe this would result in considerable legal challenge from existing generators and seriously undermine the confidence of future generators in the connection framework. Putting aside legal challenge, we do not believe Ofgem’s proposed compensation approach is tenable. There are between 3,000 and 4,000 distributed generators across the distribution networks, which would require case-by-case- negotiation to agree appropriate compensation. We believe many across the industry share our resistance to a compensation-based approach and this has been borne out by comments at the recent stakeholder workshops. We have attached a critique of Ofgem's regulatory impact assessment as a separate appendix to this submission.

On the theme of customers, we have been proactive in putting forward a measure of customer satisfaction (the net promoter score, NPS) and therefore welcome Ofgem's proposal to incorporate some form of advocacy scoring within DPCR5. We believe the current quality of supply (QoS) incentive has driven real improvements in our two distribution services areas (DSAs), but feel that customers would now benefit most from improvements in service levels where / when interruptions still occur. We see no reason why such an incentive could not be introduced early in the period to bring immediate improvements to customer service. Whilst we are open to alternative measures, NPS is supported by strong academic research and its statistical relevance and effectiveness has been subject to international testing. We feel confident that this measure is suitable for a monopoly situation given that customers will compare the service levels they receive from a DNO with those they receive from other companies outside the sector.

We welcome Ofgem's focus on addressing competition in connections in advance of the forthcoming price control period. Further to Ofgem's recognition that some form of margin is appropriate for facilitating competition, we would now expect our outstanding issue for the current price control period to be resolved and a regulated margin to be allowed on our connections activity under DPCR4.

In terms of competition in connections for DPCR5, we support Ofgem's tiered approach and the 'basket' of measures that has been put forward to determine whether competition exists or is developing. We believe one of the key indicators will be the level of interest in competitive tenders. This will determine whether there is competitive activity within a service area without penalising parties that may have the competitive edge.

On the networks theme, we have listened carefully to our stakeholders and taken their views into account in preparing our capital programmes across both our DSAs. We believe this process has strengthened our relationship with our stakeholders and opened the door to some who have not engaged with us in the past.

We recognise the rationale for extending the use of output measures for DPCR5, and believe this will give Ofgem the confidence it needs with regard to finalising the settlement package with individual DNOs. We do not believe this needs to be further supplemented with an assessment of RoRE, nor do we support a uniform approach to output measures across all DNOs. We understand Ofgem's concern that certain DNOs have significantly under spent their DPCR4 allowance, and that this is driving the more formal introduction of output measures. However, connections margin notwithstanding, we expect to spend over 95% of our capital allowance in each of our DSAs. Moreover, we are able to demonstrate that we have delivered significant improvements in our quality of supply, maintained fault rates and improved customer service. We therefore believe that a DNO-specific approach to output measures for DPCR5 is essential, and indeed will help to develop best practice going forward to DPCR6.

In terms of the actual opex allowances, we have been concerned by the lack of information regarding Ofgem's thinking at this stage in the price control review process. We are therefore pleased that Ofgem is to hold a workshop on cost driver development shortly. Notwithstanding this, whilst we support Ofgem's proposed building blocks, we continue to be concerned over the desire to carry out 'bottom up' benchmarking which has historically proven to be both time-consuming (for both Ofgem and the DNOs) and of little practical value.

With regard to additional regional costs, we are in the process of preparing a paper on the additional costs of operating in the North and Islands of Scotland and will submit this shortly. We believe that there are also additional costs associated with operating in our Southern Electric Power Distribution (SEPD) DSA and will address this in our paper. On this topic, we have not submitted any additional money in our SEPD FBPQ for the Olympics and believe, due to the uncertainty of the costs involved, that a re-opener mechanism will be required. We would welcome further discussion with Ofgem on this.

Completing the networks theme, we believe that given the condition and performance of Lerwick Power station, the Shetland pass-through term will need to be adjusted to allow both for the decommissioning costs of the power station and for the development work needed to identify an integrated, whole island solution. We discuss this further in our confidential appendix, which outlines our vision of what an integrated whole island solution could look like.

In addition to the three main themes, we agree that the financial framework will be key to ensuring that efficient DNOs are able to finance their activities in this uncertain environment.

On the cost of capital, we remain concerned that debt triggers and/or a re-opener are still being considered. As noted in our response to the initial consultation document, we believe DPCR5 should refrain from introducing any radical change and should be seen by the market as the fifth review in a consistent process. This is even more important given the uncertain economic backdrop.

With regard to pensions, we continue to believe that the current pension arrangements are appropriate and therefore welcome the fact that Ofgem is not looking to change the overall pension principles. Whilst we accept that Ofgem requires further information on pension costs to be assured that they are being efficiently incurred, we would be concerned if major changes to the existing regime were introduced as part of DPCR5.

I hope this clearly sets out our views on the policy for DPCR5. Should you wish to discuss any of the above or supporting material in more detail, please do not hesitate to contact me.

Yours sincerely,

Malcolm J. Burns
Regulation Manager.

Chapter 1: Introduction and overview

Key Messages:

- **We recognise Ofgem's concern that it has no clear way of knowing whether certain DNOs have delivered the improvements in line with their current price control settlement. We therefore support Ofgem's proposal to introduce DNO-specific output measures for the forthcoming price control period.**

- **However, we do not support Ofgem's proposal to develop a new measure of return based upon regulatory equity (RoRE). We believe return on Regulatory Asset Value (RAV) is a well-established, well-understood measure by DNOs and stakeholders alike and we are concerned that deviating from this measure will have unintended consequences.**

- **If however this approach is imposed on us, we are strongly of the view that Ofgem should not apply fixed limits on the return that DNOs can earn. Efficient, well-performing DNOs should not have their ability or appetite to out-perform curtailed by an artificial cap.**

- **We do not believe the failure of the collective licence modification to introduce the same charging methodology across all DNOs will result in inefficient investment decisions. All DNOs are working together to deliver a common charging methodology for HV/LV for 2010, which will cover around 99% of customers. We have proposed an industry working group to review the best way forward for developing more cost reflective charges at EHV. In any event, we would question the extent to which the charging methodology could reasonably be expected to influence demand customers' locational decisions.**

1. Do you agree with our assessment of how the DPCR4 settlement has performed in practice?

In our view, RPI-X regulation continues to work well. During the current period we have improved the quality of supply to our customers, maintained fault levels at a constant rate and improved customer service. We have done this during a period of significant pressure on costs. Nevertheless, we have managed our capital expenditure programme to c.95% of the DPCR4 settlement (notwithstanding the issue regarding treatment of connections margin). Going forward, we would hope to see further development of the incentive regime to focus on the environment and further improve customer service.

2. Do you agree with the main lessons we have drawn from this assessment?

We understand Ofgem's concerns surrounding the levels of return that have been made by some DNOs during the current price control period, and share the view that the highest returns have not necessarily coincided with the best performing DNOs. Whilst we welcome steps by Ofgem to try to align performance and returns in future periods, we believe the current concerns can largely be attributed to performance under the losses incentive.

However, the 5-year rolling mechanism built into the losses incentive will significantly erode returns that are not sustainable. We therefore expect the extent of the final returns under the current price control period to be less than have so far been reported and would urge Ofgem to maintain faith in the current incentive.

Notwithstanding this, we recognise that the lack of codified measures going into the current price control period has made it very difficult for Ofgem to gauge individual DNO performance against their set allowances. We therefore understand why Ofgem is now keen to establish output measures in advance of DPCR5. Whilst we agree with this approach, we are wary of having measures imposed on us that have been driven by the behaviour of other DNOs. It is therefore essential that DNO-specific output measures are developed. We do not believe a 'one size fits all' approach is best for the industry and allowing DNOs to develop their own output measures will help to identify best practice over a period of time. We have outlined our proposals in our response to Chapter 2 and will deliver our full output measures charter as part of our FBPQ submission at the end of February.

3. Have we identified appropriate measures to address our concerns and deliver a settlement that provides better rewards/penalties for highly performing/poorly performing companies?

We welcome the development of output measures as part of the price control settlement and Ofgem's current view to develop a new innovation incentive. With regard to the latter, it will be important that the incentive is flexible enough to adapt to changing circumstances. For example, the current RPZ incentive is very rigid and is not able to adequately compensate for new initiatives, as has been found with the development of active network management facilities for the Orkney RPZ.

4. Do you think our proposal to base DNOs' incentives for under / out performance around their effective return on equity is appropriate?

As discussed in previous correspondence, we do not support Ofgem's proposal to switch to a RoRE basis to determine whether modelled returns are appropriate. In our view, return on RAV is a well-defined, well-understood measure by all involved in network regulation (including stakeholders and city analysts). We do not think it is appropriate to move away from this measure for DPCR5, which is intended to be the fifth in a consistent process.

5. If you do, what range of return on equity do you think would represent a fair balance between customers' and shareholders' interests to reward increased efficiency, better service and innovation, whilst maintaining strong incentives for shareholders of any poorly performing DNOs to improve performance?

We understand that RoRE would be used to identify a 'notional band' and not to fix limits for the appropriate level of return. However, we remain concerned that it could constrain DNOs' ability to outperform. As noted in previous correspondence, we believe that a well-performing, efficient DNO should be able to earn 1% to 2% above the agreed post tax real weighted average cost of capital.

Chapter 2: Environment

Key Messages:

- **We understand the uncertainty going into DPCR5 and the challenges set by Government environmental policy. We are willing to accept these challenges and to take steps to actively pursue the best network solutions for the long-term. However, to enable this behavioural change, the framework and, in particular, the incentive mechanisms, needs to be flexible and allow for the correct allocation of risk.**

- **We believe the structure of the existing DG incentive, is broadly correct and we therefore support its continuation. However, if Ofgem is serious about driving a change in DNO behaviour, we believe the value of the incentive needs to be strengthened. The cost of connecting DG will increase going forward as the need for reinforcement increases.**

- **We do not agree with Ofgem's proposals to bring long-standing existing DG within the charging base for distribution use of system charges. We believe this would result in considerable legal challenge from existing generators and undermine the confidence of future generators in the connection framework. Moreover, we do not believe it is tenable to put in place compensation arrangements.**

- **We welcome Ofgem's proposal, in principle, to supersede the existing RPZ mechanism with a wider innovation incentive. We believe this will need to be structured as a largely upfront recovery mechanism with an asymmetrical incentive to reward successful project delivery / outturn. We believe there is further potential to incentivise through an *ex post* discretionary reward type approach. We look forward to developing the new incentive under the auspices of the Environmental Working Group.**

- **We support Ofgem's proposed approach to losses. We believe the retention of the current output measure is key to maintaining the loss reductions that have been delivered in the current price control period. The proposed input element will help to focus the DNOs' attention on measures to address 'technical' losses.**

1. **Do you agree with our view of future uncertainties and the need for DNOs to change their way of working and thinking to encompass innovation and flexibility?**

   2010 to 2015 is widely expected to be a period of change and we agree that there is considerable uncertainty given that the technologies that will emerge successful and go on to shape the future network are, as yet, unknown. We support Ofgem's proposals to adopt a proactive approach and to put in place a settlement package that will support and facilitate the DNOs in making these changes. In our view, flexibility will be essential to ensure that DNOs can adapt to changing circumstances.

However, in recognising this uncertainty, we believe Ofgem must take a very different approach to downside risk. Whilst we accept that DNOs cannot expect zero risk, we do not believe that we should be overly exposed to technology failure or the risk that the rate of market change means that technologies deemed innovative today are quickly superseded and subsequently redundant. We believe flexibility within both Ofgem and the DPCR5 settlement will be key to ensuring that the DNOs have the correct framework to pursue the variety of network solutions that will need to be tested over the next price control period.

2. **What are your views on our proposals for DNOs to provide more information to help low carbon initiatives and have we adequately identified and defined the information requirements?**

Whilst not opposed to greater information *per se*, we believe it is key that the information that is made available is targeted. We would be concerned about a mandatory package of measures that focused on the volume of information rather than on the clarity or appropriateness of that information. Specifically, we do not believe an indicative connection costing tool is of real benefit to prospective developers or customers. We believe this could prove to be misleading.

We believe some of the issues regarding the provision of information are more to do with awareness of information that is already available. The immediate focus should therefore be on ensuring that developers and customers are made aware of what information is already provided. We understand that this view was expressed by stakeholders at the recent workshops.

3. **Do you agree with our proposal that all distributed generation should pay use of system charges, and if not, can you provide evidence to substantiate your specific concerns?**

Ofgem is aware of our strong concerns regarding any proposal to bring long-standing existing DG within the charging base for distribution use of system charges. This DG was connected under an entirely different commercial and regulatory regime and the introduction of use of system charges not only risks undermining the profitability of the generation and potentially its commercial viability, but also risks raising legal issues associated with property rights. Contrary to Ofgem, we believe that a lack of clear rights set out in these generation contracts underlines that we cannot interpret the legal text to suggest that these generators have no rights. Indeed, we would expect such generators to argue the opposite to Ofgem's view, i.e. that unless they are specifically excluded, they have firm rights and would expect to be compensated.

Furthermore, we do not believe it is tenable to implement Ofgem's proposed change by providing pre-2005 connected generation with some form of compensation. As previously discussed, such compensation would need to be on a case-by-case basis and given that some 3,000 to 4,000 generators would be impacted, this would be a vast exercise. We believe this view is shared by many across the industry and concerns to this effect have been expressed at the recent stakeholder workshops.

In July 2006, we provided Ofgem with our detailed concerns and expressed these same concerns at the Environmental Working Group. Whilst Ofgem has responded (17 October 2008), we do not believe that our concerns have been alleviated. We continue to believe that the effort required to identify and agree suitable compensation is disproportionate to the perceived problem.

We therefore do not support Ofgem's proposal to mandate DNOs to develop revised charging arrangements for all DG on the same basis by 2012. We do not believe the current arrangements are a barrier to DG connection *per se*. We believe Ofgem's efforts to explore, for example, more flexible administrative arrangements and to introduce sharper / more appropriate incentives to drive DNOs to consider and, where feasible, deploy innovative solutions, will be more instrumental in bringing DG on than destabilising the current charging arrangements.

We have provided a critique of Ofgem's regulatory impact assessment as a separate appendix to this submission and, where appropriate, commentary in response to Ofgem's letter dated 17 October 2008.

4. Do you agree that the distributed generation (DG) incentive should be retained? Should embedded transmission be deemed relevant DG?

We support the retention of the current DG incentive. We believe the structure of this incentive is broadly correct and only small-scale changes are required to roll it forward into DPCR5. For example, we believe there is merit in moving towards a single charging pot and ensuring that there is sufficient flexibility in the mechanism to accommodate any changes that trigger a significant increase in DG connections beyond current forecasts.

We are concerned by suggestions that the value of the incentive could be reduced in DPCR5. We understand that Ofgem is disappointed with the level of DG that has connected during the current price control period. This is due to many issues, not least planning and transmission constraints. The cost of the DG that has connected has been low and this is in part because the incentive rightly drives the most efficient connections, i.e. those requiring least reinforcement. However, it does not provide a strong driver on DNOs to actively seek to connect DG, particularly those that require network reinforcement.

Where DG can connect without the need for reinforcement, the current mechanism provides a small incentive (£2 k/MW connected at most); where shared reinforcement is required, it acts as a cost-recovery mechanism. Going forward, we envisage that more DG connection will require network reinforcement due to the lack of spare capacity on the network. Unless the current incentive is strengthened, we believe the incentive on DNOs to connect DG will reduce in DPCR5. If Ofgem is serious about putting in place a framework to change DNO behaviour, we believe it must develop a stronger incentive; one that persuades the DNOs to connect DG both with and without reinforcement.

We agree with Ofgem that embedded transmission should be treated as relevant DG and incentivised under the same framework to ensure connection efficiency.

5. **What are your views on our proposals on innovation and flexibility? How would you rate their feasibility and which option is most likely to drive the more innovative and flexible behaviour that we are seeking?**

We have championed the existing RPZ mechanism with the development of our initiative on Orkney. However, we recognise that the existing mechanism is limited to embedded generation and that Ofgem is keen to widen the scope of the current incentive to enable DNOs to explore and develop wider-ranging solutions in line with changing demands and market conditions. We believe Ofgem's proposal to develop an 'innovation incentive' to put in place the necessary framework to incentivise DNOs to take a more innovative role that considers the potential longer-term benefits, is a positive step. The difficulty is that the extent of the uptake of these future solutions and their exact nature is uncertain. Any new incentive will need to be sufficiently flexible to enable development of both demand-side and generation-based solutions.

The main issue with seeking to drive innovation is that the technologies and approaches being trialled are not well-tested or understood. For DNOs to want to take a more innovative approach and to start to consider alternatives to the more conventional network solutions, they must be able to develop and trial initiatives without unreasonable exposure to project costs and/or penalties. We believe this includes exposure to additional customer interruptions or minutes lost as a result of installing innovative equipment (from both the actual installation and potential 'bedding-in' problems).

We do not therefore believe that Ofgem's proposed option 3 is appropriate. In our view an *ex-post* assessment of innovative projects with minimal or zero upfront funding cannot drive the required behavioural changes across the DNOs. We believe there must be a clear recovery mechanism for at least a significant proportion of the costs invested / incurred.

Similarly, we do not believe it is appropriate to require individual project proposals to be submitted to Ofgem for approval prior to commencement. Although this would de-risk the process, it will place a bottleneck in the critical path of all prospective projects and result in significant work for Ofgem. Instead, we believe there is merit in adopting an approach akin to that used in the Innovation Funding Incentive (IFI), where Ofgem create a cost recovery mechanism and industry develop a good practice guide for Ofgem's approval. This cost recovery mechanism could be based upon avoided capex or network capacity made available, and be applicable to both existing and new infrastructure.

In addition to cost recovery, Ofgem will need to incentivise DNOs to change their behaviour. At its stakeholder workshops earlier this year, Ofgem highlighted the importance of incentives in driving desired behaviours. For the purposes of innovation, we believe that this will need to be an asymmetrical incentive: with limited downside should the project fail to deliver the stated benefits, but with the potential to earn a reasonable return where the project is successful.

In our view, a sliding-scale approach, not dissimilar to that used in the current IQI mechanism, could be developed to accommodate the different appetites for risk across the DNOs and between project proposals, whereby DNOs could decide the level of risk / reward balance that they are willing to accept for each project put forward. Again, this would enable Ofgem to establish clear and upfront rules relating to project funding at the time of setting the price control, removing the administrative burden of case-by-case project negotiation. We believe there is real value in this approach for both Ofgem and the DNOs. It may also be necessary to allow innovative regulatory and commercial arrangements such as excluding directly-related CIs and CMLs from the interruptions incentive scheme and accommodating other knock on increases in operating costs.

We believe that each project's success could be judged against a set of output measures defined by Ofgem prior to the inception of a project. This is consistent with steps being taken elsewhere to ensure a clear measure of successful delivery. In any case, we believe it will be key for Ofgem to clearly set out its funding and reward mechanism to ensure that DNOs have confidence in the cost-recovery mechanism. It may be most appropriate to do this through the licence. We look forward to developing an appropriate incentive mechanism through the Environmental Working Group forum.

Building on Ofgem's thinking, we believe a further incentive could be provided through a discretionary reward at the end of the price control period. This would allow Ofgem to reward particular examples of innovation best practice through a financial bonus being awarded to the DNO (or DNOs) considered to be at the forefront of innovation on their distribution network.

We understand that the innovation incentive is one of a number of measures being designed to encourage DNOs to consider the alternatives to reinforcement and that it should be considered as part of a package. However, later in this response, we have set out our concerns surrounding proposals to equalise capex and opex incentives as we do not believe this is appropriate. In our view, any concerns regarding incentivising non-network solutions should be addressed through the innovation incentive and <u>not</u> through equalising capex / opex incentives. We believe there are unintended consequences from discouraging the DNOs to invest in their networks, which cannot be ignored. In particular all non-statutory capital investment, such as that for quality of service or reducing losses, would be curtailed.

Finally, we do not agree that only projects that are suitable for wider-spread roll-out should be approved. This will limit island-specific innovation. Whilst we recognise that Ofgem is keen to use the incentive to drive best practice across GB, we believe a restriction on one-off projects is both counter to the intent of the incentive, i.e. until trialled there is uncertainty surrounding any innovative project as to whether, in practice, it will be suitable for further roll-out, and this approach could stifle some of the most innovative solutions, elements of which may turn out to be suitable for further roll-out.

6. What are your views on our proposal to set an incentive on transmission grid exit charges?

We are surprised by Ofgem's suggestion that DNOs could, in some way, be incentivised to manage transmission grid exit charges. These costs, which are based upon asset condition rather than the volume of electricity exiting the network, are already subject to incentive regulation under National Grid's price control. We therefore do not believe that there is any rationale for placing a further incentive on the DNOs, particularly when we are not responsible for, or have any control over, National Grid's asset replacement programme. We firmly believe this should remain as a pass-through item.

7. **What are your views on our losses proposals, and do you have any additional comments on the option to install smart meters on low voltage substations?**

   We accept that all DNOs should report losses in the same way. In our view, units exiting the system should be reported using corrected settlement data from the D030 data flow. The use of corrected data will help to minimise volatility, which is a concern of some DNOs.

   We are very aware of Ofgem's concerns over the out-performance being achieved by some DNOs under the current output-based losses incentive. We believe concerns over out-performance will, to a large extent, be mitigated by the in-built five-year rolling nature of the incentive, provided that it is allowed to fully play out. The current incentive rewards DNOs for sustainable and continued year-on-year reductions in losses and this element of the incentive has not been reflected in the revenues that have been the focus of Ofgem's attention to date.

   Despite an increase in losses in 2007/08, we believe that overall the output incentive has achieved what it set out to do, i.e. it has incentivised DNOs to focus on reducing losses.

   Furthermore, we recognise that the present focus for reductions in losses has been on 'non-technical' measures and that Ofgem is keen to tackle technical losses during DPCR5. We support Ofgem's proposed approach to encompass an input-based element within the current framework and to refrain from undue auditing of specific capex projects by making use of the existing output measure and the additional output measures that are being planned for DPCR5. We do not support the view that output measures will prove ineffective as a result of the volatility in settlements data. We believe the retention of an output measure will ensure that progress made in the current period with regard to data cleansing is sustained.

   Given the reductions in losses achieved during the course of the current price control and the rewards received for these reductions, we believe DPCR5 targets need to reflect recent history to avoid over-rewarding DNOs for the same reductions. We support Ofgem's initial proposal of 5 years' history or less.

   In terms of Ofgem's proposal to install smart meters on low voltage substations, we remain of the view that the costs and timescales to install the necessary metering are excessive and do nothing to bring about lower losses. We have over 50,000 ground and pole-mounted transformers in each of our licensed areas and estimate the costs for installing appropriate meters, i.e. those with higher tolerances, to be c. £65 m in SHEPD's area and c. £115 m in SEPD's area. Moreover, this additional investment does nothing to actually reduce losses, it merely allows us to better identify them. We believe this money would be better spent on more direct measures to bring down losses, e.g. investment in low loss transformers, over-sizing cables and network voltage optimisation.

8. **What are your views on the various aspects of the business carbon footprint proposals?**

   There is a balance to be struck between encouraging DNOs to minimise their environmental impact versus the incurred costs and corresponding value for money for customers. We received strong feedback during our stakeholder engagement process that any money allocated to tackling carbon should be spent where it can have most environmental impact. DNOs' activities account for just 1.3% of total GB greenhouse gas (GHG) emissions, and losses account for c.97% of this. Therefore, excluding losses, the DNOs' business carbon footprint can be calculated to account for less than 0.04% of total GB GHG emissions.

   That said, we believe it is right to drive down our environmental impact wherever possible, but believe that this should be subject to proportionate measures. The requirement to report low carbon initiatives was discussed at the Environmental Working Group. At that time, all DNOs expressed concern over the administrative costs of data collection for what is c.3% of their total GHG emissions and 0.04% of total GB emissions. Whilst we welcome the decision to base business carbon footprint reporting on the Greenhouse Gas Protocol, we remain concerned over the proportionality and the costs involved in this reporting. In particular, we are concerned by the need to renegotiate contracts in order to report emissions from outsourced activities. We are not convinced this is proportionate given the level of emissions involved.

   In addition, in formulating proposals in this area, it will be necessary to consider the interaction with the forthcoming Carbon Reduction Commitment (CRC). It will also be necessary to ensure cost recovery for any costs incurred in reasonably complying with this new Government incentive.

9. **What are your views on our proposals for refining the undergrounding scheme? In particular, should we apply caps per km of cable by voltage level or should we remove all voltage caps and just have a single overall cap?**

   The feedback from our stakeholder engagement supports Ofgem's proposal to retain the current funding of undergrounding by customers. We believe the success of this initiative to date has been restricted by the caps on unit costs across GB, which do not accommodate the range of terrains in certain service areas. Ofgem's proposal to increase the caps is therefore welcomed, although we would argue that this does not go far enough for undergrounding at HV level. In addition, we have received specific support from our environmental stakeholders to include some element of flexibility in the caps where there is wide stakeholder agreement that a higher value project should go ahead.

   Some of our environmental stakeholders were also keen to see the current allowance extended to include, for example, conservation areas and National Park gateways and peripheries.

   In terms of allocating the allowance pot, we are not opposed to Ofgem's proposed methodology.

10. Do you agree with our proposed approach for the treatment of fluid-filled cables?

In our response to the initial consultation document, we proposed the development of an incentive to reduce the risk of leakage from fluid-filled cables. We recognise the environmental risk presented by fluid-filled cables and therefore continue to believe that such an incentive would be a positive contribution to minimising our environmental impact.

In terms of what we are already doing, we have in place risk-based guidance to ensure that planning staff target those areas that are not only most cost-effective, but also at highest risk from leakage, both in terms of cable condition and environmental impact. Our 'Management of Fluid-Filled Cables' manual defines our operational response to these issues and contains guidance on maintenance, inspection, leak detection, leak data collection and trigger leakage rates. Finally, the leakage history of all cables is contained in our Placar database and reports are prepared to update our Management Book, inform outside agencies and aid planners to identify and designate cable sections for replacement.

Chapter 3: Customers

Key Messages:

- **We welcome Ofgem's focus on competition in connections during the current price control review. We believe Ofgem's tiered approach to promoting competition, starting with a regulated margin, and its proposed 'basket' of competition tests are a significant step forward. We look forward to working with Ofgem in developing the appropriate tests for competition.**
- **In addition, we welcome Ofgem's recognition that some form of margin is key to facilitating competition and expect our outstanding issue for the current period to be resolved and a regulated margin to be allowed on our connections activity.**
- **The Interruptions Incentive Scheme (IIS) has driven considerable improvements in our performance across our two distribution service areas (DSAs). We aim to continue to improve our CI and CML performance in line with targets, but recognise that customer service also needs to be targeted.**
- **We therefore support Ofgem's proposal to introduce a strong measure of customer satisfaction in the forthcoming period. Net Promoter Score (NPS) is an internationally-tested measure backed by significant academic research and we believe it will drive real improvements in customer service levels. We believe it should be possible to introduce an incentive based upon this measure early in the price control period.**

1. Do you think that the range of existing and proposed arrangements will deliver the levels of service customers expect?

Yes. We have found the current IIS incentive to be a strong driver of improved interruption performance. Since the start of the incentive, in 2000/01, we have significantly reduced the number and duration of interruptions in both our DSAs. We therefore believe that the scheme, and the benefits that it brings to customers, should be continued.

Whilst the IIS has helped to reduce both the number and duration of interruptions, there will always remain a 'background' level of interruption events. From a customer's perspective, we believe the level of service received during an interruption event is a key factor in how customers perceive the overall level of service that they have received. A customer that suffers an interruption, but is able to make direct contact with its distributor and is kept suitably informed, is more likely to go away happy with the service. We believe the current quality of supply incentive fails to address the value that customers place on excellent customer service and the impact that excellent service can have on minimising the level of disruption / inconvenience caused.

We therefore welcome Ofgem's proposal to develop a broader measure of customer satisfaction and to design a new incentive to reward / penalise DNOs according to the satisfaction of their customers. We believe this provides for a more complete quality of service measure and should therefore be deployed at the earliest opportunity. We envisage that a period of 1 to 2 years should be sufficient to give a robust benchmark in this area. Importantly, we believe Ofgem must adopt a common baseline across all DNOs.

2. What percentage of revenue/return on equity should be exposed to customer service and how should it be split between the various areas?

In our response to Ofgem's initial consultation document we set out our view that the current overall level of exposure for IIS (± 3% of base revenue) is about right. As discussed, we believe Ofgem's proposal to introduce a customer satisfaction measure sits best within this IIS measure and we would suggest that Ofgem adjusts the weighting attributed to CIs and CMLs in order to accommodate this new measure within the existing ± 3% level of exposure, for example:

	DPCR4	**DPCR5**
CMLs	± 1.8%	± 1.0%
CIs	± 1.2%	± 1.0%
Customer Satisfaction	-	± 1.0%
Total	**± 3.0%**	**± 3.0%**

3. Do you agree with our intention to develop a broad measure of customer satisfaction and the proposed advocacy approach?

We support the review of the current quality of service initiative to ensure that the measures in place are focused on delivering the improvements that are most relevant to today's customers. To this end, we believe the current telephony incentive is not as effective as it could be. Whilst we believe Ofgem's proposed changes to the incentive will mark an improvement, we have been proactive in putting forward a well-understood and internationally-tested measure of customer satisfaction, which we believe could supersede the telephony incentive and prove a much stronger driver of improved customer service performance early in the next price control period.

We note Ofgem's concern regarding the applicability of NPS in a monopoly market given that the focus of the survey is whether customers would be prepared to recommend the company to a friend or colleague. However, we believe that customers are unlikely to consider the competitiveness of the market in discussing excellent customer service. Therefore, whilst in practice customers might not be able to change their distributor, we believe this is unlikely to impact upon customers' readiness to score highly in the survey where they feel that the service received was of such a level that they would go out of their way to recommend it to a friend or colleague. Moreover, customers will tend to compare a company's level of service, not necessarily with that of its competitors, but rather with that of other companies with which they have had involvement, e.g. Tesco, BT, Direct Line, etc. Importantly, this single question used in the NPS exceeds the statistical relevance of any other question tested.

We have some concern with the approach that has been adopted by the Office of Rail Regulation (ORR) given that the alterations made to the scoring system have resulted in some of the statistical relevance being lost from what is a proven concept. For example, a sample of 10 customers who are ambivalent to the service received, would score zero collectively under the ORR's approach. This is very different to the score that would be achieved under the traditional NPS system (-10). If, in a further sample of 10 customers, 5 customers score +2 and 5 score -2, the result is again zero and the ORR's approach fails to capture or recognise the difference in value to the company between the two samples. In contrast, the NPS system would record a difference of 10 between these two samples.

We believe the appointment of a market research agency to undertake the surveys independently would give Ofgem (and other DNOs) confidence that the surveys were being undertaken consistently.

4. Do you agree with our proposed approach to connections, which of the options do you support and why?

We welcome the focus that Ofgem has placed on developing a practical and pragmatic approach to competition in connections ahead of the forthcoming price control period.

In particular, we support Ofgem's recognition that in order for competition to develop, the DNOs must be allowed to earn a margin. Whilst the appropriate level of the proposed 'regulated' margin will depend upon market conditions, we would suggest that a net margin of around 10% is not unreasonable.

In line with this latest policy position, we now expect our outstanding issue in relation to connections margins for the current period to be resolved and a regulated margin to be allowed for our connections activity.

We also support Ofgem's proposal to move away from a single market share-based assessment of competition to a 'basket' of competition tests. We believe market share, in isolation, is an insufficient indicator of competition. High market share can indicate competitive pricing along with excellent service levels, and is therefore not necessarily denotative of a market that is closed to competition. For this reason, we consider one of the key indicators of competition to be the level of interest in competitive tenders. This measure will demonstrate the number of competitors within a service area without penalising those that have a competitive edge.

Notwithstanding the above positive steps that Ofgem has taken with regards to facilitating competition in connections, we are concerned by the implication that where there is little or no evidence of competition by the end of December 2013, Ofgem will refer the host DNO to the Competition Commission (CC). We do not believe this is appropriate action where a DNO has taken all reasonable steps to ensure that competition can develop. We believe any CC referral should be limited to circumstances where DNOs have deliberately taken steps to close their market to competition and not where the level of competition is outside their control.

5. **Do you agree with the proposed amendments to the IIS (in full) and what are your views on how incentive rates should be structured?**

   We do not believe that the proposed amendments to the 2014/15 unplanned benchmarks are necessary and we would suggest that Ofgem refrains from retrospectively adjusting methodologies (and targets), which have already been agreed and implemented.

   In terms of the targets themselves, we would encourage Ofgem to break (or weaken) any assumption that improvements in CML performance will automatically or ultimately lead to a reduction in the number of customer interruptions. We have taken significant steps to reduce both the number and duration of interruption events across both our service areas and are planning to invest in increased automation to help to deliver the reductions in CMLs that will be required to meet the 2014/15 targets in SEPD's DSA. Whilst this will reduce the number of minutes lost, it will have little or no impact on the number of interruptions on the network. We believe further improvements in CIs across our DSAs are limited without disproportionate investment and are not necessarily backed by customers according to the latest willingness to pay surveys. We would therefore urge Ofgem to guard against making the assumption that improvements in CMLs should drive a tightening of future CI targets.

   To maintain confidence in the incentive mechanism we support robust steps to ensure that DNOs are not funded twice to deliver IIS improvements. Specifically, where DNOs have failed to meet their targets at the end of the current price control, further funding should not be provided to bridge the gap between any shortfall in current performance and the starting point for 2010/11.

   Finally, whilst we understand that there may be benefits in looking at the longer-term impacts of investment in measures to improve quality of service, we do not believe this is an appropriate time to put in place a longer-term incentive.

6. **Do you agree with our proposed long-term objective of DNOs being able to automatically know which of their customers are off supply and the exact times, and if so what is the appropriate timescale to achieve this?**

   We recognise the importance of good communication to our customers, particularly during periods of outage, and we are keen to take steps to improve our performance in this area. We believe the introduction of a strong customer satisfaction measure within the existing IIS initiative will drive significant improvements in the near-term and at relatively low cost.

   Going forward, we recognise that there is value in customers being able to access real time information and we would be keen to work with Ofgem to explore options and develop potential solutions. However, we believe the initial focus should be on carrying out a full regulatory impact assessment on the proposal. We also consider that there are possible linkages with this proposal and Government's plans to roll-out smart metering.

7. **Do you agree with the proposed focus on worst served customers and which of the options do you prefer?**

   Whilst we understand and support Ofgem's drive to improve service levels to worst-served customers, the proposals set out by Ofgem in its policy paper would, at best, award SHEPD £8.0 m and SEPD £4.5 m across the price control and, at worst, £1.1 m and £2.1 m respectively. Moreover, we understand that the cost of providing improvements to worst-served customers is to be capped at £1,000 per customer. The proposals set out by Ofgem are therefore insufficient to deliver the schemes necessary to make a real difference to worst-served customers and, in particular, schemes designed to deliver at least a 25% improvement.

   Aside from the size of the allowance, in terms of how this allowance is allocated, we are not opposed to an even split across all the DNOs. However, it would seem more logical to allocate the fund according to the number of worst served customers in each DSA.

8. **We have raised some detailed questions throughout this chapter and the appendix. We welcome views on these issues.**

   Aside from Ofgem's proposal to include a more effective measure of customer satisfaction and our proposal to include this within the current IIS initiative and incentive weighting early in the forthcoming price control period, we believe the structure of the quality of service incentive is broadly correct.

   We are sceptical of the proposals outlined in the policy document and appendix to change the parameters of the scheme. Specifically, we do not believe changes are needed to the severe weather thresholds and how risk is allocated during one-off events. A considerable amount of time was spent developing the existing mechanism and we are concerned that changes to the mechanism could result in unintended consequences that could provide less favourable outcomes for customers.

Chapter 4: Networks

Key Messages:

- **We are fully supportive of developing a suite of output measures to ensure that our customers receive value for money. We will shortly provide Ofgem with the output measures that we expect to be judged on during DPCR5 and look forward to developing these further during the price control period.**

- **However, we do have a very serious concern regarding Ofgem's continuing interest in equalising incentives for opex and capex. We believe that this is both misguided and dangerous. It is very clear to us that such a move would have the perverse consequence of dis-incentivisng DNOs to invest in their networks. It would lead to an absolute minimal capital investment programme (to meet statutory requirements) with no investment to improve the quality of service, reduce losses, etc. Furthermore, such action would completely undermine the positive steps being taken to incentivise DNOs to contribute towards the UK's 2010 carbon targets.**

- **The Information Quality Incentive (IQI) proved a strong incentive in DPCR4 and we believe it should be retained in DPCR5. We would discourage Ofgem from adopting a tiered approach in response to output measures. We believe this would be overly complex and open to challenge.**

- **With regard to the comparative efficiency analysis of DNOs' costs, we have previously expressed our views regarding the usefulness of some statistical approaches. We have also been critical of the benefit of any 'bottom up' approach to benchmarking and are concerned about the lack of transparency in the work that Ofgem is currently undertaking. We therefore welcome the proposal for a Cost Review meeting, but have suggested that this needs to wait until after the FBPQs have been submitted.**

1. **Have we identified the right behaviours for DNOs? Are there others which should be included?**

   We believe the behaviours identified by Ofgem are generally correct. They are challenging, but achievable providing the correct regulatory framework is put in place. In particular:

   - We agree that there is a need to incentivise DNOs to take a longer-term approach to network investment and alternative solutions, and the correct incentive mechanisms will be key to ensuring that this change in emphasis is facilitated;
   - We understand and support the rationale for the increased use of output measures to ensure that Ofgem can better measure whether customers have received value for money during the price control and whether DNOs have delivered in line with their commitments; and
   - We welcome the positive steps taken by Ofgem to encourage greater competition in connections.

2. **What action should we take where a DNO has deferred investment and created a backlog in DPCR4?**

   We are of the opinion that the price control settlement is an overall package agreed between the DNOs and Ofgem. Whilst we can sympathise with Ofgem's concerns over deferred investment, where a DNO has successfully been able to defer investment that was planned to take place during the current price control period, we do not believe any action is required, provided such action was efficient. The price control framework will automatically 'log down' the RAV for unspent capex after 5 years. We would be concerned that further negative sanctions would reduce incentives to deliver capex efficiently, including efficient deferral.

   We could, however, possibly make an exception to the above policy where the scale of deferrals is such as to question the legitimacy of the original business plan.

3. **What approach should we take to deal with volume uncertainty?**

   Whilst we agree that a revenue driver based on units distributed is no longer appropriate, we would suggest that a customer number driver is still required; it is clear to us that network costs will increase as customer numbers increase.

   We welcome the proposal to develop a form of capex driver for the uncertainty of connections going forward. Our view is that some form of (symmetrical) sliding scale mechanism would be most appropriate. We would welcome discussing and developing this with Ofgem at future Policy Group meetings.

4. **What approach should we take to price uncertainty?**

   Our industry is facing substantial uncertainty due to the current economic climate. We agree with Ofgem's view that it may be appropriate to set an *ex ante* allowance based upon our forecast increase in input prices along with a trigger level beyond which appropriate indexation would apply. We look forward to discussions on the appropriate trigger level and form of indexation.

   Due to the level of uncertainty, we agree that the information quality incentive mechanism should exclude the impact of changes in real prices.

5. **Should we be looking to equalise incentives for opex and capex? If so, what approach should we adopt?**

   We are strongly against Ofgem's proposal to equalise incentives for opex and capex. We believe such a move will throw up unintended and perverse consequences that are not in the interests of customers or the long-term health of the networks.

   Arbitrarily treating a certain percentage of costs as capex will result in the percentage of costs that is added to the RAV being detached from the actual level of network investment. We believe that any such detachment will drive most DNOs to reduce their capital expenditure programmes to the absolute minimum necessary to meet their statutory obligations. As a consequence there will be no additional investment to improve quality of supply, tackle worst served customers, reduce losses, etc. and, over time, quality of supply could be expected to deteriorate. In particular, it is clear that only allowing a percentage of investment in the RAV will make virtually all investments uneconomic. This is a fundamental shift away from RPI-X regulation towards a model that looks more like rate-based regulation, only with strong incentives to under rather than over invest.

We are surprised by the level of support across the DNOs to move towards equalising incentives. We believe this is a measure of how difficult the DNOs, across the piece, are finding it to minimise their exposure under the current opex allowance and how keen they are to support measures that will reduce their opex exposure in the forthcoming price control period. We believe this is a clear signal that the focus across the DNOs is on minimising their opex exposure. Consequently, we do not believe Ofgem's proposal will necessarily deliver the desired objective of increased opex-based solutions in place of capex. In our view, this will be best delivered through developing the new innovation incentive and strengthening existing incentives, such as DG.

However, we believe there is benefit in a limited review of the current split of costs that are capitalised to RAV at building block level. We have already put forward our proposals in this area, but have replicated these below for completeness.

Category A (100% Capex)	**Category B (100% Opex)**	**Category C (Split btwn Capex & Opex)**
Load Related Capex	Non Operational Capex (exc. Land & Buildings)	Faults
Non Load Related Capex	Inspections & Maintenance	Engineering Management & Clerical Support
Non Operational Capex: Land & Buildings	Tree cutting	Vehicles & Transport
Network Design & Engineering	Network Policy	Stores
Project Management	Control Centre / Call Centre	
	System Mapping	
	IT & Telecoms	
	Property Management	
	HR & Non Op Training	
	Health & Safety & Op Training	
	Finance & Regulation	
	CEO etc	

We support Ofgem's objective of encouraging DNOs to think more innovatively about how they bring on embedded generation and accommodate demand. However, we believe it is imperative that Ofgem does not lose the current 100% capitalisation treatment of load related and non-load related network costs. We therefore believe the focus of Ofgem's attention in driving the required behavioural change should be on the incentive mechanisms and, as noted, the innovation incentive has the potential to be a key driver in this area.

6. **Do you consider that we should make refinements to the IQI? If so, what changes should we make?**

The existing IQI mechanism proved a strong incentive and effective driver in encouraging DNOs to submit accurate forecast business plans during DPCR4. We strongly support its retention going into the forthcoming price control period and see no reason why the strength of the incentive needs to change. Arguably, the need to submit accurate forecasts will be further backed by the increased use of output measures.

We do not believe that it will be practical to establish a two-tier approach for IQI based upon the quality of output measures brought forward by DNOs. In our view such an assessment will be subjective and open to challenge.

7. **What action should we take where DNOs provide insufficient output information as part of their February FBPQ?**

Notwithstanding our ongoing concern over treatment of the connection margin in the current price control period, we are on target to achieve c.95% of our allowed capital expenditure by the end of 2009/10. We have done this whilst improving CIs and CMLs, maintaining fault rates, and improving customer service.

For DPCR5 we will provide, as part of our FBPQ submission, a comprehensive suite of output measures across all three of the price review themes (Environment, Customers and Networks). We believe that our network output measures will allow an *ex post* assessment of our capital expenditure. However, whilst some of our proposed output measures have been used for a number of years, others (such as a general health index) are new and will require some development.

To recognise this, we have developed three categories of output measure: gold, silver and bronze, with gold measures being the most established and bronze measures requiring greatest refinement and flexibility during the initial years of the price control. We have at least one gold measure in each of the three themes. We believe this tiered approach allows us to put in place the most relevant and effective output measures at this time.

Importantly, we would urge Ofgem to refrain from making a simple causal link between agreed output measures and expenditure. In the main, the relationship between performance and spend will not be linear. Moreover, the output measures are highly interactive and a reduction in performance in one area will have a knock-on effect on another.

8. **Do you agree with our proposed approach to assessing network operating costs and indirect costs?**

In our response to the initial consultation document, we noted our concerns regarding the statistical robustness of the available data. We remain concerned that the data is not sufficiently robust for the intended purpose.

Whilst we are supportive of Ofgem's 'building block' approach, we continue to have doubts about the usefulness of any bottom up comparative analysis. As discussed in our response to the initial consultation document, in our view such an approach simply captures differences in cost allocations due to different business practices.

We strongly believe that DNOs should be involved in the development of any new benchmarking techniques and welcome Ofgem's proposed Cost Review Meeting following the submission of the FBPQs.

9. Do you agree with our proposed approach for assessing network investment?

We recognise Ofgem's concerns regarding the level of under-spend by certain DNOs against allowed capex during the current price control period. Whilst in some cases this may suggest a lack of investment, we believe this concern has been exacerbated by:

(i) The capex profiles adopted by many DNOs during the current period, i.e. low capex spend in the early years followed by much increased spend towards the end of the period; and
(ii) The lack of clarity surrounding the treatment of connection margins.

To this end, we strongly support the present focus by Ofgem on agreeing a methodology for the treatment of connections margins ahead of the forthcoming price control period.

On the basis that we included connections margin in our forecast capex spend for DPCR4, we are on track to outperform our capex allowance by a relatively small percentage (c.5%). Importantly we have delivered this out-performance through efficiency savings and are confident that we have delivered, in full, the programmes of work that derived our current settlement. We have done this whilst improving quality of supply, maintaining fault levels and improving our customer service.

Chapter 5: Financial issues

Key Messages:

- **With regard to the cost of capital, we agree with Ofgem's analysis that debt indexation could erode one of the core foundations of RPI-X regulation. However, we remain concerned that dept triggers and / or a re-opener are still being considered.**
- **Given the current economic turmoil and the very real prospect of the next price control period being within a deflationary or very high inflation environment (and possibly both), it may be worth considering whether to set a cap and collar on RPI indexation.**
- **On the question of tax, we agree that setting an upfront allowance is the best of the alternative policy options. However, in our view it is worth exploring whether there are any expected future changes in tax law that can be codified within the price control.**
- **Finally, with regard to pensions, we continue to believe that the current pension arrangements are appropriate and therefore welcome the fact that Ofgem is not looking to change the overall pension principles. Whilst we accept that Ofgem requires further information on pension costs to be assured that they are being efficiently incurred, we would be concerned if major changes to the existing regime were introduced as part of DPCR5.**

1. **Have your views on the appropriate methodology for setting the cost of capital or on indexing the cost of debt changed as a result of the current turmoil in the capital markets?**

   No, we remain of the view that introducing debt indexation, or debt triggers, would be overly complicated and impractical. We continue to believe that DPCR5 needs to be seen by the market as the fifth in a consistent process. Given the current turmoil in capital markets we believe this is even more the case.

   However, given the current economic turmoil it may be appropriate to explore the option to place a cap and collar on RPI indexation. This may be particularly relevant as we enter a period of deflation, the length of which remains speculative.

   On the Treatment of Taxation
   We agree that setting an upfront allowance is the best alternative policy option. In our view, it may be worth exploring whether there are any known changes that can be codified ahead of the price control.

   With regard to the clawback of tax benefits of excessive gearing, we have responded to your letter on this topic separately.

On the topic of modelling of capital allowances, we are firmly of the view that the specific approach, which uses the actual DNO tax pool allocation and capitalisation policies, should be adopted. The treatment of capital expenditure across capital allowance pools is very much dependent on the individual DNO's capital expenditure programme.

2. What is the appropriate timing of actuarial valuations for setting *ex ante* pension allowances (see also appendix 10)?

We welcome Ofgem's decision not to change the overall pension principles and instead focus on whether licensees are responding correctly to incentives to mitigate and manage pension costs effectively, and whether it continues to be appropriate to accept all the assumptions used by scheme actuaries when setting price controls.

As we set out in our response to the 2008 consultation on Price Control Pensions Principles, we continue to believe that the independence of trustees from licensees and the fact that many schemes include a significant number of members whose costs are funded by non-regulated businesses, therefore providing incentives to keep costs down, go a long way to addressing Ofgem's concerns.

The following are our comments on the specific topics set out in Appendix 10 of the policy paper:

Deficit recovery periods
We are pleased that Ofgem appears to have discounted extending deficit recovery periods beyond the ten year trigger used by the Pension Regulator. However, we still cannot support a generic funding period given that schemes have differing maturities, age profiles, investment strategies and valuation dates. This would be inequitable, exposing companies to different cash impacts. Recovery periods should be consistent with the recommendations of scheme actuaries as accepted by trustees and companies.

Capitalisation into RAV
We support the treatment of pension costs consistent with other salary costs, with respect to recovery through the RAV.

Appropriate actuarial valuation for setting price control allowances
The Policy Paper offers three options: (i) continue to use the latest triennial valuation; (ii) base the allowance on companies' assessment of their pension costs; or (iii) introduce a re-opener when a new regular full triennial valuation is published. We favour option 2, supported by work from the scheme actuaries, as this methodology is most likely to match funding with cash outgoings and minimise any detrimental cash impact, and also subsequently require smaller *ex-post* adjustments.

Pension administration costs
We welcome Ofgem's decision not to benchmark pension administration costs, recognising that the total costs are not material and that trustees are sufficiently incentivised to ensure that the schemes' costs are efficient.

Treatment of scheme mergers

We support Ofgem's conclusion that it is not cost effective to have an annual actuarial assessment of the split between regulated and unregulated members and instead to agree with companies the appropriate attributions.

Stranded surplus

We accept that Ofgem intends to monitor schemes for symmetry in the treatment of a surplus with that for funding deficits, and that if a scheme were in surplus for an extended period then allowances would be adjusted if contribution levels were not. This seems a reasonable approach given that in practice we do not believe that it is likely that material surpluses will arise.

Chapter 6: Process

1. **We invite views on which format stakeholders would find most useful for the Ofgem workshops to be held in January 2009.**

   These workshops have passed.

2. **We invite views on our proposed process.**

   The timetable continues to be very challenging and we firmly believe that ongoing dialogue at all levels will be essential leading up to the initial and final proposals. We welcome the continuation of industry workshops and expert working groups and will take an active role in these.

   We continue to believe that some form of update from Ofgem will be required around September. This may take the form of an update letter from Ofgem to individual DNOs.