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Dear Rachel,

Electricity Distribution Price Control Review: Ofgem Methodology and Initial Results Paper

Scottish and Southern Energy plc (SSE) welcomes the opportunity to respond to Ofgem's Methodology Paper.

In all previous price controls, we have been at the efficiency frontier. In terms of our capital investment forecasts, we have bid accurately and delivered against these forecasts. We have maintained fault levels and delivered improvements in our customer service. In short, we believe we have acted efficiently and responsibly. Therefore, whilst we are supportive of many aspects of the current price control review, we believe we have raised a genuine concern over Ofgem's proposal to equalise incentives and that this should be fully explored.

We support Ofgem's regression analysis of operating costs. We believe Ofgem's modelling is robust: the relative efficiencies and therefore rankings of the DNOs remain consistent regardless of the costs, drivers and methodologies applied. However, whilst we are fully supportive of Ofgem's approach to opex benchmarking to date, we are concerned that Ofgem will react to individual DNOs' proposed methodologies and changes. We firmly believe Ofgem needs to adhere to its quantitative approach that it has presented so far. In addition, we believe Ofgem should strengthen the efficiency incentive by moving to an average approach rather than the currently applied upper quartile.

We are also supportive of Ofgem's efforts in relation to determining the DNOs' capital requirements. In particular, we believe Ofgem's pragmatic approach of allowing the DNOs to provide evidence to influence Ofgem's assessment where their approach deviates from Ofgem's assertions or modelling is very positive and we are keen to continue to work with Ofgem to ensure that its analysis is as accurate and as reflective of our networks and programmes as possible.

Similarly, we support Ofgem's introduction of output measures and believe that the steps taken by Ofgem to date in introducing these have been both proportionate and appropriate. We believe this is consistent with the evidence-based approach that has been adopted by Ofgem in developing its view of appropriate forecasts and believe that these measures will provide both Ofgem and stakeholders with more comfort regarding the eventual DPCR5 settlements.

That said, we are concerned that Ofgem is now trying to drive the DNOs down a common 'one-sizefits-all' methodology, which we do not believe is appropriate for DPCR5 given that this is a new approach and the variances across the DNOs. We do not believe it is appropriate to compare the DNOs and are concerned that the development of a common methodology will lead to this.

However, our single biggest concern is Ofgem's proposal to equalise incentives.

We accept that there are some advantages to the new incentive regime. It does address the current capex and opex trade-off, although it is questionable how real these trade-offs are in practice. It also reduces the risk of opex overspend and mitigates (to some extent) the burden of regulatory reporting (although we have yet to see firm plans on how this will be delivered).

However, we do not believe these concerns are sufficient to warrant the level of overhaul being proposed. That is not to say that equalising incentives does not address these concerns, but rather that we are concerned that this approach creates complex and perverse incentives. Moreover, we believe this level of change cuts across the current RPI-X @ 20 review, which is looking at many of the issues that Ofgem is now attempting to bring in and resolve under DPCR5.

An equalised approach has two main perverse effects. It rewards DNOs for under investment in the network and, at best, halves the incentive to make operating cost efficiency savings.

Again, whilst we understand Ofgem's concern of incentivising over-investment in the networks, we believe an incentive that does the reverse is wholly inappropriate for the long-term health of the network and customers. Once the allowances are set, the optimum economic strategy / commercial incentive is for a DNO to reduce its investment. This is at odds with many of the other policies being driven forward, for example, more active connection of distributed generation, innovation (be it capex or opex-based solutions), reduced losses on the network, improvements for worst-served customers, etc.

In terms of opex, it reduces the incentive to make efficiency savings. We believe the support expressed by some stakeholders is driven largely by the desire to weaken penalties for opex overspend (and to increase the potential reward from any capex under spend) and not for the reasons outlined by Ofgem (i.e. to encourage more innovative solutions to network investment).

We believe a more proportionate and appropriate approach to address the perceived capex / opex trade-off and to encourage innovation is to develop the proposed new innovation incentive and to allow demand-side measures in the RAV. We believe there is value in structuring this incentive to address the different incentive rates that currently exist on capex and opex, i.e. by rewarding opex-

based solutions in a way that is akin to capex and by removing any adverse, knock-on effects on subsequent regression analysis. We believe this is within the remit of DPCR5 and presents a more pragmatic and targeted approach to the perceived problem.

I hope this clearly sets out our areas of support and also our genuine concerns surrounding the complicated issue of equalised incentives, which we believe could seriously risk the long-term health of the network. I think it would be extremely useful to meet to discuss this in more detail and will contact you shortly to discuss and hopefully arrange.

Yours sincerely,

Malcolm J. Burns **Regulation Manager**.

Chapter 3: Operational cost assessment methodology and results

Key Messages:-

- § We are supportive of Ofgem's comparative efficiency work. Despite applying a number of different techniques and cost drivers, the relative efficiency of the DNOs remains constant. We believe this gives confidence that Ofgem's approach is a strong indicator of relative efficiencies.
- **§** We believe Ofgem's comparative analysis should be the major factor in setting DPCR5 operating allowances and that Ofgem should base allowances in DPCR5 on the average rather than the upper quartile. This will ensure that there continues to be a strong efficiency incentive for frontier-performing companies.
- **§** We are unclear how the proposal to include benchmarked operating costs within the Information Quality Incentive (IQI) will work in practice. All DNOs will need clarity on this ahead of the initial proposals.

1. Have we exposed the correct costs to comparative benchmarking?

We are supportive of the costs that Ofgem has included in its benchmarking analysis and its decision to separately assess the DNOs' IT and property costs. With regards to this work, we would ask that Ofgem shares any final reports on these separate cost areas with the DNOs.

On a separate, but important point, we believe there is a strong rationale for basing DPCR5 allowances on the average rather than the upper quartile. This is consistent with the move from frontier to upper quartile in DPCR4 and will ensure that there continues to be a strong efficiency incentive for all DNOs. In addition, to some extent a move to average costs mitigates concerns raised by other DNOs about the accuracy of the efficiency assessment.

2. Do you agree with the assumptions we have made for our core analysis?

We support Ofgem's decision to include related party margins in its core comparative analysis and to exclude pensions and any singleton adjustment. Related party margins are simply another cost and to exclude them from the analysis would be counter-intuitive to the intent of Ofgem's benchmarking work. With regards to the singleton adjustment, this was deemed to be time limited at the point it was introduced and we believe it is now no longer appropriate.

We do not however support the exclusion from the core analysis of costs associated with 'alliance' contracting. We do not believe these costs are any different to other costs and as such do not understand the rationale for their exclusion. In any case, we believe these costs should be a sensitivity to Ofgem's analysis rather than part of the core / base analysis.

In addition, we note the proposed adjustment to EdF LPN's costs to account for increased labour and contractor costs. These increased costs are not specific to EdF LPN; they are incurred by all DNOs operating within the M25. As such, we would argue that Ofgem needs to apply a consistent approach and exclude the effects of these costs from all affected DNOs. Similarly, we have submitted a paper highlighting the increased costs of operating in the north of Scotland. This needs to be taken into account in Ofgem's benchmarking work to ensure consistency and comparability.

3. What are the appropriate cost drivers for each of the cost groupings?

We are again broadly supportive of the cost drivers employed and believe that the ability to apply alternative drivers to certain costs, without having a knock-on effect on the relative efficiencies of the DNOs, instils considerable confidence in Ofgem's comparative analysis.

In particular we welcome the use of log-log regressions. We have achieved a high level of consistency in our approach across our two licence areas; this consistency is more effectively captured by a log-log approach, which factors in company size. That said, we believe our two businesses have individual differences that Ofgem should reflect. In SHEPD, the unique geographic situation requires acknowledgement and an appropriate allowance to offset this. In SEPD, we are under the same input cost pressures within the M25 corridor as the EdF companies. Again, we believe this needs to be recognised in our allowance.

Notwithstanding the above, we would however welcome greater clarity around the 'asset hours work' driver for inspections and maintenance. It is not clear to us the basis of this driver and how it is derived.

4. How should we determine baselines for the costs excluded from comparative benchmarking?

Where Ofgem has involved external consultants to review the DNOs' forecasts, i.e. costs relating to IT and property, we believe Ofgem should, providing the consultants consider the forecasts to be reasonable, award the DNOs an allowance that is in line with their forecasts.

In other identified areas, i.e. wayleaves, insurance, submarine cable faults and remote location generation, we believe Ofgem should base DPCR5 allowances on DPCR4 average costs. This will maximise incentives for efficiency.

5. How should we treat atypical costs in the price control settlement?

The current price control period has been a period of low atypical costs, through, for example, extreme weather events. However, unlike other cost areas, it is not prudent to base future allowances on a short history. Instead, we believe it is more prudent to take a longer-term view of historic costs and to base allowances on an industry average rather than DNO-specific costs given the uncertainty of where and when these costs may occur.

6. What weight should we give to the benchmarking relative to other considerations?

We believe that Ofgem's work on benchmarking, in conjunction with the consultant review work, should be the principal mechanism for deciding DPCR5 opex allowances. Ofgem has expended a lot of time, effort and resource in conducting this work and has given consideration to sufficient drivers and sensitivities to give us confidence in the results.

We are therefore concerned that para 3.97 of the Methodology Paper will lead to a qualitative assessment rather than a quantitative approach:-

"Our benchmarking results form an important input into our assessment of the DNOs' efficiency and highlight where there are potential issues in the DNO forecasts, but are part of a wider set of information that we will use to determine baselines."

It is key that Ofgem is clear about what it means by a "*wider set of information*". We are concerned that this could expose Ofgem to qualitative arguments, which could undermine the incentive properties of benchmarking. Ofgem has, for example, already sought to exclude costs relating to 'alliance contracting'. We do not fully understand the rationale for this exclusion and / or whether this same adjustment should apply to other DNOs. In order to have a robust settlement, we believe consistency in approach is key. We therefore believe that any qualitative inputs should be limited to providing a 'sense-check' of the outputs of the regression analysis.

Finally, we do not believe the international benchmarking is robust. We believe Ofgem's assessment fails to recognise the definitional and boundary issues between North America and GB DNOs, and the inherent operational and cultural differences between the two. Separately, we believe the conclusion that GB DNOs have scope for further efficiency gains is contradictory to the proposal to move to an equalised incentive approach. By equalising incentives, the incentive on opex is weakened; this is counter-intuitive in an environment where further efficiency savings are believed to be possible and should therefore be strongly incentivised.

On the separate issue of including operating costs within the Information Quality Incentive in DPCR5, we supported this, in principle, in Ofgem's Policy Paper, providing these costs were clearly identifiable and controllable. Whilst we stand by this, our concern with Ofgem's latest proposal is that it is not clear to us how the allowances for operating costs will be determined and treated. There is an inconsistency in applying the Information Quality Incentive (IQI) to historic, regressed costs when it was initially designed and introduced to reward accurate forecasting. Equally, it would be wrong to use the IQI to reward or penalise the alignment of the DNOs' forecasts (forward-looking) with the outputs of Ofgem's benchmarking work given that this is on an entirely different basis (i.e. backward-looking).

We would therefore welcome clarity from Ofgem at the earliest opportunity on its intended application of the IQI to operating costs and how it plans to set the DNOs' operating allowances.

We believe the simplest approach may be to establish the relevant column within the IQI matrix based solely on the accuracy of capex forecasts, i.e. to add the opex allowance (based upon the historic regressions) to the capex allowance once the IQI column has been derived. This will overcome the issue of trying to 'fit' a historically derived opex allowance into a mechanism designed to reward forecasting accuracy.

We believe the IQI was very successful in driving the DNOs to put forward accurate capex forecasts in DPCR4. In order to ensure that it remains as effective in DPCR5, we believe Ofgem should retain the same matrix as was used at DPCR4. The gas matrix offers a weaker incentive and this may be reflected in the accuracy of the DNOs' forecasts. Weakening the incentive at a time when all DNOs are forecasting increased costs does not seem appropriate.

Chapter 4: Methodology - Core network investment

Key Messages:-

- We are very supportive of Ofgem's combined model and evidence-based approach to determining its non-load related forecasts. Ofgem's model is a pragmatic starting point and its supporting evidence-based approach ensures that Ofgem does not overlook or penalise DNO-specific approaches to asset replacement where they are appropriate.
- **§** We believe a modelled approach is less appropriate for informing load-related forecasts given the associated uncertainty. We believe the focus in this area should be on an evidence-based approach, with any modelling taking a secondary role.

1. Do you agree with Ofgem's approach to assessing core network investment allowances based on the wide range of evidence detailed in the chapter?

Ofgem's non-load related capex modelling provides a good starting point and we welcome the opportunity to work with Ofgem to address areas where Ofgem's modelling suggests a lower allowance than we are forecasting. We believe this is a pragmatic approach and alleviates our initial concern over the potential to limit revisions to areas of higher cost. However, we note that there are a number of areas where Ofgem's model shows our forecasts to be lower than predicted by the model. It is important that Ofgem takes a balanced view of a DNO's forecasts and factors this into its final approach for setting the allowances.

The area of modelling future load-related capex is more problematic. This is made more challenging by the current economic climate and we have concerns that the current model will be unable to deal with the leading and lagging aspects of load-related investment and the change in the nature of the load as a result of the current climate. Recognising the limitations of any modelling, we are fully supportive of an evidence-based approach to support and improve modelled outcomes (as has been adopted for non-load related costs).

The core areas of network investment are well covered by Ofgem's approach. However, it is the volatile nature of demand forecasting, weather forecasting, energy efficiency drivers and large individual customer requests that impose uncertainty on these costs. It is not entirely clear how Ofgem intends to address / accommodate these uncertainties. We have put forward our proposals in Chapter 10.

2. Do you agree with the primary network general reinforcement modelling methodology that Ofgem has adopted for DPCR5?

We have concerns over the ability of any model to forecast investment in this difficult area, particularly given the current economic uncertainty. Whilst we believe Ofgem's proposal to apply both a capacity / demand growth and capacity cost / long run average cost approach is reasonable, we believe the complexities of modelling the associated investment is reflected in the fact that Ofgem's load-related model is less developed than its asset replacement model. We therefore believe the focus in relation to load-related investment must be on an evidence-based approach, with any modelling taking a secondary role. An evidence-based approach is further supported by Ofgem's introduction of output measures.

Importantly, for reasons discussed in Chapter 8, we do not believe it is viable to use load-related investment modelling to compare across the DNOs given the diversity of approaches and drivers, for example, network topography and historic network investment patterns.

3. Do you agree with the asset replacement modelling methodology that Ofgem has adopted for DPCR5?

In order to get an initial view of likely future asset replacement across the DNOs, we believe Ofgem's age-based model provides a pragmatic starting point. However, where the DNOs are able to provide evidence that supports variances in the modelled outputs, we believe it is key that this evidence is taken into account. A number of asset types cannot be accurately modelled on age alone given DNO-specific asset stewardship policies. For example, our 12-year overhead line refurbishment policy, which is well established and dates back over a number of price control periods, does not lend itself to being modelled and benchmarked against other DNOs' rebuild programmes. We have been supportive of Ofgem's approach to date and are keen to work with Ofgem to provide the evidence necessary to support the continuation of this programme.

More generally, we would expect the evidence required to be commensurate with the volumes, type and time horizon of each particular asset type.

4. Is the outlined process for developing Initial Proposals suitable?

Yes, we believe Ofgem's proposals are suitable.

Chapter 5: Network investment – Environment

Key Messages:-

- § We recognise the importance of minimising the environmental impact of our operations and have been broadly supportive of the steps taken by Ofgem in this key area.
- **§** Whilst slow to develop in DPCR4, we believe the volume of distributed generation (DG) will increase in line with forecasts in DPCR5. As such, we believe Ofgem should refrain from making significant changes to the DG incentive framework, which might undermine this development.

1. Do you agree with our approach to assessing the forecasts of distributed generation, discretionary expenditure and losses and are there any other factors you think we need to take into consideration?

We continue to believe that the DG incentive is broadly working, it has simply taken longer to bed in than was initially foreseen. We have, for example, recently seen a high number of non-relevant applicants refreshing their requirements and becoming relevant connections. In addition, the volume of general DG under construction has picked up significantly in recent months and we would expect both Ofgem's proposals for connect and manage and the Government funded grants for renewable energy to increase this further. Importantly, in SHEPD's area, we are observing a substantial increase in the proportion of schemes requiring reinforcement relative to DPCR4. This reflects the fact that the DG that has connected during DPCR4 has used the spare capacity on the network.

For all these reasons, we would strongly recommend that Ofgem does not dilute the existing incentive to reflect historic DG volumes and connection costs. Indeed, we would argue that there is no sound rationale for basing the incentive on the cost of connection. In addition, we do not believe it is appropriate to apply an average approach and incentive rate across all the DNOs given the likely range. An average cost approach will result in less renewable build in Scotland. This was recognised going into the current price control period and we do not believe this should change in DPCR5.

We do not believe Ofgem's approach to assessing discretionary expenditure or losses is particularly clear from the Methodology Paper and we look forward to exploring this further. Notwithstanding this, in respect of losses, we believe any system to reduce losses must be both simple and easily managed. Although not covered in the Methodology Paper, we have put forward expenditure for lower loss transformers and larger cables in our February FBPQ submission, and we believe this approach is both effective and transparent in targeting technical losses on our networks.

Finally, it is worth noting that under Ofgem's proposals for equalising incentives, investment in DG, discretionary spend and losses will no longer be economic. As such, many of the measures and incentives being discussed here and elsewhere would become ineffective under an equalised incentives regime.

Chapter 6: Ongoing efficiencies and input prices

Key Messages:-

- § **RPI-X** regulation has reduced costs to the customer, in real terms, by 50% since privatisation. The big savings have been made and further, ongoing efficiency savings will clearly be more modest. It nonetheless remains important to retain the focus on efficient operation going forward.
- § SSE has been at the efficiency frontier in all previous price reviews and retains this position going into DPCR5. Our assessment, based on managing frontier companies through four price controls, is that a 0.5% per annum 'frontier shift' is achievable during DPCR5.
- **§** Whilst comparator industries can be used to indicate the potential frontier shift going forward, it will be important to balance this with the knowledge of what has been achieved by the electricity network businesses to date.
- **§** With regards to real price effects, we suggest that the DNOs should be allowed their forecast increases in input prices, but with a trigger mechanism to accommodate the ongoing uncertainty. If triggered, we believe there is merit in linking input prices to an agreed index.

The DNOs have been operating their networks since 1990/91, through four price control periods. RPI-X regulation has been effective in reducing the operating cost of the distribution networks, by 50% since privatisation.

However, the next significant frontier shift is likely to come from a change in how the businesses are operated, probably as we move towards managing a more dynamic network in DPCR6. Until then, ongoing efficiencies will be hard won. We therefore believe that the current aim must be to promote and reward innovation across all three major themes: the environment, customers and networks. As noted in our covering letter and our response to Chapter 9, we do not believe that equalising capex and opex incentives will achieve this aim.

1. Have we identified the most relevant unit cost and productivity measures from other sectors to help inform our ongoing efficiency assumption for DPCR5?

We note that Ofgem is continuing to use the EU KLEMS dataset based upon the Reckon LLP approach used at GDPCR. We are mindful that Frontier Economics offered some constructive criticism of that approach at the time and would urge Ofgem to bear this in mind going forward.

We welcome the proposal to examine both the gross output and value added measures of productivity and unit costs at this stage.

2. When calculating these measures, which comparator sectors and time periods should we focus on?

Finding suitable comparator industries is difficult. A pragmatic approach is required, along with a clear understanding that, whatever comparators are used, the relative efficiency can only be used

to help inform Ofgem's view of the likely ongoing efficiency of the DNOs. This is discussed further in our response to Q3 below.

Notwithstanding this, we are not clear why Ofgem considers that the two sectors (manufacture of electrical and optical equipment and manufacture of transport equipment) are comparable industries to electrical distribution network operators. DNOs construct, operate and maintain transportation networks; we do not manufacture goods. In this vein, we are also unclear why the 'manufacture of chemicals, chemical products and man-made fibres' sector is relevant.

When assessing the relative efficiency of comparator industries, we agree that Ofgem should use long-term trends. It is sensible therefore to use the full EU KLEMS dataset for comparator industries. However, again it is important to understand that the average historic efficiency of any industry or sector cannot simply be used as an indication of future efficiencies for that industry or sector.

3. What weight should we give to this analysis relative to other information?

In our view, whilst assessment of the relative efficiency of comparator industries provides a reasonable sense check on what can be achieved by the DNOs, Ofgem should be careful of placing undue weight on this work. Both Ofgem and the DNOs have been through four price control reviews and are therefore best placed to understand the business and the potential for further efficiency gains.

As noted above, we have been at the efficiency frontier in operating and maintaining our networks through those four price controls. We understand our networks and are well placed to provide a robust and realistic view of what frontier shift can be achieved over the next price review period. As noted in our FBPQ submission, we expect to achieve an ongoing efficiency across all business costs, inspections & maintenance costs and fault costs of 0.5% per annum.

Our June update to the February FBPQ will continue to reflect this view. Our assessment takes account of the potential for improvements that have not yet been identified.

We note that CN has assumed c.2.7% efficiency improvements year-on-year in DPCR5 and we suspect that this efficiency improvement may reflect that it was the last DNO to merge and its desire to catch up. However, it must not be considered to be an indication of what frontier shift is achievable across all the DNOs, particularly for those already at the frontier.

4. What method should we use for setting our input price assumptions for DPCR5?

We note CEPA's work and its critique of the First Economics' work, which formed the basis of our (and some other DNOs') FBPQ submission on real price effects.

We believe that the First Economics' report is robust, and understand that First Economics will shortly be meeting with Ofgem to discuss the differences between their and CEPA's assessment. One key area of difference is wage increases. CEPA's analysis assumes wage increases that, at best, match average earnings growth. Whilst First Economics will no doubt comment on this themselves, we would also refer Ofgem back to our February FBPQ submission and our supporting narrative on salary inflation.

We believe that the evidence we provided in our February FBPQ, supported by the First Economics' report, is robust. Given the ongoing period of recession, we do not believe it is appropriate or practical to carry out a further review of this work. We suggested in our February FBPQ submission that given the uncertainty, it may be appropriate to set an *ex ante* allowance for each DNO based upon their forecast increase in input prices, along with a trigger level beyond which an agreed index (or basket of indices) should apply. We continue to believe this is the best way forward.

Chapter 7: Customers

Key Messages:-

- § In relation to worst served customers, we believe Priority Customers should be the key focus for the limited funds available.
- § Ofgem has weakened the Interruptions Incentive Scheme (IIS) on the basis of its customer willingness to pay survey. Whilst we understand the logic, we are not convinced by the results.
- **§** We believe Ofgem should reward DNOs who are already at their 2015 target. This maintains the precedent set at DPCR4.

1. Do you agree with the proposed mechanism (in full) for worst served customers?

We believe the proposed mechanism is broadly appropriate and are supportive of the proposed mechanism to allocate the fund. However, neither the capex allowance nor the cap per customer are sufficient to warrant the DNOs taking the risk involved in not delivering against the required 25% improvement in customer interruptions. We believe a more appropriate cap per customer is $c.\pounds2,000$ – more than double what is currently being proposed.

We also believe that Ofgem should consider directing the mechanism towards worst-served Priority Customers. This would focus the small and limited investment that is available on areas where it is most needed. This may allow Ofgem to consider caps per customer that are more realistic to the types of project / work that is required.

As a final point, under Ofgem's proposal for equalising incentives, investment in this area will be loss-making (since DNOs only receive £0.80 in the RAV for every £1.00 spent). There is therefore no point in retaining this proposal if Ofgem proceeds with its plans to equalise incentives.

2. Do you agree with the proposed approach (in full) for setting unplanned targets for customer interruptions and customer minutes lost?

Whilst not opposed to the revisions made to the IIS *per se*, we believe it is key that Ofgem presses on with its development of a customer satisfaction measure to ensure a comprehensive suite of measures to improve customer handling and experience. To this end, we welcome the dedicated working group that Ofgem has set up to take this forward.

Ofgem's proposed changes to the CI and CML incentives have diluted the strength of the incentives and as such we no longer believe it is appropriate to include the customer satisfaction measure within the current IIS cap and collar of 3% of revenue. We support Ofgem's latest proposal to expose 0.5% of revenue to this new incentive. In developing this new satisfaction incentive, we believe it is key that Ofgem adheres to a well-developed / well-tested approach. Customer satisfaction is very difficult to monitor and unless a robust mechanism is deployed, we believe the credibility and effectiveness of the incentive will be called into question.

In terms of our CI and CML unplanned targets in SHEPD's area, where we are already meeting our 2015 targets, we believe a precedent has been set in DPCR4 whereby WPD was awarded an annual 'quality reward' to reflect the fact that it was already at its 2010 CML target at the start of DPCR4. We would expect this same adjustment to apply to SHEPD in DPCR5.

Finally, whilst not clear in the methodology paper, we assume that the CI target is based upon a four-year DPCR4 average. Also, we note that the May Methodology Paper is silent on how prearranged targets will be set. We would welcome early clarity from Ofgem on both of these points.

3. Do you think that we should set a cap on the cost per benefiting customers within the worst served customers mechanism and, if so, what level should this be set at?

Worst-served customers (WSCs) are worst-served because of the cost in improving the level of service that they receive. Through our stakeholder engagement programme with customers in our worst-served areas, we received compelling feedback that the focus of our investment in this area should be on vulnerable WSCs.

Similar to our proposals for funding work in AONB, we believe there is merit in setting indicative caps, below which the DNO can carry out projects as it sees fit. For any projects that are expected to exceed this cap, we believe there should be sufficient flexibility in the mechanism to allow these schemes to go ahead where there is evidence of stakeholder agreement and a robust business case.

Chapter 8: Network output measures

Key Messages:-

- § We are supportive of Ofgem's proposal to introduce output measures in DPCR5 and will continue to work with Ofgem to develop the measures that we have so far put forward.
- **§** We do not believe that it is appropriate to seek a common 'one-size fits all approach' across the DNOs in DPCR5 given the different approaches to network investment. For this same reason, we do not believe it is appropriate to use these measures to compare across the DNOs.

1. Is Ofgem's proposed methodology for general reinforcement and asset replacement outputs appropriate?

We are concerned by the clear drive in the Methodology Paper to develop a common methodology, particularly for the area of asset replacement where all DNOs are already demonstrating appropriate measures.

We are concerned that Ofgem is driving us towards a common 'one-size fits all' approach in order to be able to compare across the DNOs. We do not believe this is appropriate; nor do we believe it is consistent with a more innovative framework. Whilst we believe there is merit in the proposed health index, we believe the breadth of different approaches adopted by the DNOs in relation to their asset replacement programmes (i.e. in terms of data, plant types, applications and risk tolerances), will mean that any comparison across the DNOs is both ineffective and unhelpful.

In terms of a common load index, we believe this is more difficult to achieve due to the variability of factors that will impact upon any load index (i.e. demand growth, number of hours outside firm and number of customers at risk). Secondly, given the uncertainty surrounding general reinforcement in DPCR5, we believe the output measures in this area will have to be flexible. We envisage the output measures in relation to general reinforcement as being a means of providing Ofgem with the information it needs to understand what has been delivered for the agreed settlement, rather than as a target level of load-related investment that will be expected during the period. Again, we do not believe it will ever be appropriate to compare across the DNOs given the different factors driving load-related investment across the different networks.

2. Is Ofgem's proposed approach for other areas of investment appropriate?

By targeting the key areas of load and non-load related investment, we believe Ofgem's proposed approach is both pragmatic and proportionate. Time can be taken to develop output measures for other areas of investment during DPCR5.

3. What approach should be taken if a DNO fails to deliver the agreed outputs i.e. how could the incentives be adjusted?

In previous price controls, Ofgem has been unable to link the health of the network at the end of the 5-year price control period and the overall performance of the DNOs back to their *ex ante* 5-

year settlement. There has been a concern that this is a potential short-coming in terms of gauging whether customers have received value for money, and the introduction of output measures in DPCR5 is a positive step forward in this respect.

It is our view that the agreed outputs should act as a trigger for Ofgem to challenge any DNO's spend where the outputs have clearly not been met. In making this challenge, DNOs must be given the opportunity to explain why they have been unable to deliver on their set outputs. Importantly, DPCR5 will be a learning period for output measures. It is expected that DNOs will develop their output measures and improve their effectiveness and robustness. Therefore, whilst it is important that Ofgem is able to use the output measures to highlight and question areas that are below expected performance, we believe a pragmatic and qualitative approach will be required during DPCR5.

4. Do you consider that the output measures proposed provide sufficient protection in their own right, or is it appropriate to have some form of additional safety net in the DPCR5 settlement, for example through monitoring investment volumes?

We believe that high-level output measures, along with clear guidance on how they are to be assessed, will be sufficient. The proposal to monitor investment volumes is inconsistent with the intent to move towards an output-based approach and Ofgem's drive to encourage more innovation on the networks. The more restrictive the measures, the less scope there is for a DNO to find and pursue potentially innovative opex solutions within the price control. We believe Ofgem needs to be mindful of ensuring that it does not adopt a micro-management approach for network investment.

5. Should there be an obligation on DNOs to further develop output measures during DPCR5?

We would expect the output measures in place going into DPCR5 to require further and ongoing development to ensure that they effectively monitor the desired outcomes. We do not believe it is appropriate or necessary to place an obligation on the DNOs to do this during DPCR5; rather we envisage that it will be in the DNOs' best interests to develop their output measures to ensure that they can demonstrate to Ofgem that they have delivered against their DPCR5 settlement.

6. We seek views from stakeholders on the role that outputs should play in DPCR5 and particularly how they can best be implemented and used.

N/A

Chapter 9: Cost incentives

Key Messages:-

- § Our single biggest concern with DPCR5 is the proposal to equalise incentives.
- **§** We believe an equalised approach has two main perverse effects: (i) it rewards DNOs for under investment in the network; and (ii) it halves the incentive to make operating cost efficiency savings.
- § We believe an equalised approach is a disproportionate response to the problems / concerns identified with the current incentive framework. We believe a more appropriate approach would be to focus on the proposed innovation incentive and to review how demand-side measures are treated / rewarded.
- Moreover, equalising incentives in DPCR5 would cut across Ofgem's two-year RPI-X
 @ 20 review.

1. Do you agree with our proposed approach to equalising incentives?

We recognise that there are a number of advantages with Ofgem's proposed new regime in terms of: (i) addressing the capex / opex trade off (to the extent that this is actually an issue in practice); (ii) mitigating (in part) the complexity of regulatory reporting; and (iii) reducing the financial exposure caused by opex overspend.

However, we question how real and significant these problems are in practice. In DPCR4, for example, all DNOs under spent against their capex allowance and overspent on their opex despite the incentive mechanisms rewarding the reverse behaviour. As such, we believe Ofgem's proposed solution is unnecessarily heavy-handed and certainly too fundamental a change for DPCR5, particularly given the current RPI-X @ 20 review. The introduction of an equalised approach in DPCR5 would cut across this important two-year project.

We therefore have serious concerns regarding Ofgem's proposal to equalise incentives in DPCR5 and believe that it leads to a number of complex and perverse incentives.

This approach marks a fundamental shift from how we currently manage and invest in our networks. At present, we are incentivised to invest in the network; an equalised approach reverses this and rewards DNOs for under-investing. Therefore, whilst for every £1 of capex spent under the current regime, £1 is added to our RAV, in an equalised scenario, just £0.80 is added to the RAV. The other £0.20, whilst being funded through our allowance, is effectively wasted. Therefore the optimum economic strategy / commercial incentive once the allowance is set, is for the DNO to reduce its investment in the network.

This disincentive to invest strikes us as wholly inappropriate for customers, the long-term future of the business and climate change targets. Contrary to Ofgem's intent, we believe it provides a very strong incentive to avoid investment in areas of discretionary spend and innovation. Instead, it drives the DNOs to find the lowest cost, short-term solutions, which are unlikely to be the most innovative, environmentally-friendly or appropriate for the longer-term health of the network. Similarly, the optimum strategy is not to promote any form of new connection, be it demand or

DG, since each new customer represents a cost. As such, there is the perverse incentive to delay, not aid, planning enquiries as this will help to avoid investment.

In addition, under an equalised approach, the incentive to make opex efficiency savings has been halved. At present, for every £1 of opex saved, DNOs see £1 p.a. of benefit. Under an equalised approach, this benefit is reduced to £0.52 (£0.80 at 40% plus £0.20 at 100%). Indeed, the situation is worse than this. Whilst under the current mechanism this benefit is realised in the year in question, under an equalised approach the reliance on the capex roller mechanism means that much of this benefit will be logged up and is dependent upon this mechanism being properly recognised in 2015 in order to be remunerated.

As a result of this reduced opex efficiency incentive, the penalty for overspending on opex has also been halved. We believe it is this reduced exposure to opex overspend under an equalised approach that is driving the support of some stakeholders.

We believe a more proportionate and appropriate approach to address the perceived capex / opex trade-off and to encourage innovation is to develop the proposed new innovation incentive and to allow demand-side measures in the RAV. We believe there is value in structuring this incentive to address the different incentive rates that currently exist on capex and opex, i.e. by rewarding opex-based solutions in a way that is akin to capex and by removing any adverse, knock-on effect on subsequent regression analysis. We believe this is within the remit of DPCR5 and presents a more pragmatic and targeted approach to the perceived problem.

2. Have we identified the most appropriate costs to be within the equalised incentive and the IQI?

Notwithstanding the fact that we fundamentally disagree with the proposal to equalised incentives, if Ofgem was to impose this in DPCR5, we believe it is appropriate to apply a 'totex' approach to IQI and that the costs identified are appropriate.

3. How should we set the "RAV additions percentage" that will determine the split between split between "slow" and "fast" money?

Again, whilst we fundamentally disagree with the general approach, it is important to recognise that a historically-derived "RAV additions percentage" will not necessarily be reflective of what should be added to the RAV in DPCR5. On average, the DNOs have submitted capex forecasts that are 65% higher than anticipated outturn capex in DPCR4. Therefore, whilst in DPCR4 80% of the costs now being considered for a near totex approach have been capitalised, this percentage is unlikely to be appropriate going forward. Indeed, given the interaction between capex and opex, we believe it will be difficult to understand the implications of the overall price control package until we see the final proposals.

Chapter 10: Managing uncertainty

Key Messages:-

- **§** We generally prefer to manage risk within the price control settlement and are keen to limit the number of re-openers and trigger mechanisms.
- § However, there are four key areas where we believe a mechanism to deal with uncertainty will be required. These are in relation to: (i) input prices; (ii) load growth; (iii) a step change in demand-side management; and (iv) re-powering Shetland.

1. What balance should we adopt between mechanisms to manage specific risks (such as input price uncertainty) and a more general type of re-opener to manage a wider basket of risks?

We are keen to limit the number of re-openers and special mechanisms. Where this is unavoidable, our preference is for a simple approach. Notwithstanding financial issues or the need to maintain suitable re-openers for legislative changes such as the Traffic Management Act (TMA), we believe uncertainty can be contained to four key areas:

- (i) Input prices;
- (ii) Load growth;
- (iii) Smart grid / innovation; and
- (iv) Shetland.

(i) Input prices

On input prices, as noted in our response to Chapter 6, we believe an *ex ante* allowance should be set based on our forecast increase in input prices. Alongside this, we believe there is merit in using a relevant index (or basket of relevant indices, i.e. copper, aluminium, BEAMA and fuel prices) to derive a 'dead-band'. Whilst the relevant index remains within this band, we would agree to take any exposure on our *ex ante* allowance. However, if the chosen index reaches the upper or lower bounds of this band, we believe this could trigger a review (not necessarily a revision) of the DNOs' *ex ante* allowances.

(ii) Load growth

We believe that a broadly similar approach could apply to load-related expenditure, albeit the index would clearly also need to take account of a measure of network activity (e.g. customers and / or capacity).

For high volume, low value projects, we believe it may be appropriate to develop a revenue driver mechanism based on the cost apportionment costs per connection, similar to the mechanism already in place in our transmission business for DG connection.

(iii) Smart grid / innovation

Should we see an unexpected step change in the development of smart grids, or other innovation during DPCR5, then we believe this will need to be addressed through a re-opener mechanism.

(iv) Shetland

With regard to Shetland, we are currently discussing with Ofgem the appropriate approach to replacing Lerwick power station. Whilst it is appropriate to continue with the current 'Shetland term' (possibly updated / revised to reflect the latest view of costs), which covers the ongoing additional balancing costs incurred by SHEPD until the power station is replaced, a specific reopener of the term will be required to assess the ongoing additional costs of any replacement power station / integrated solution.

2. What risks should be covered by specific mitigation mechanism, by a general type of reopener, and which should be left to the DNOs to manage?

Please see our response to Q1 above.

3. Are there any additional risk mitigation mechanisms that we should be considering that are not identified in this chapter?

In response to Q1 above, we have identified the need for additional risk mitigation with regard to re-powering Shetland.

Chapter 11: Tax methodology

Key Messages:-

- **§** We believe that the allocation of capital expenditure to tax pools should be on a DNO-specific basis.
- **§** We agree with Ofgem's proposal of a symmetrical sharing mechanism, subject to a trigger being activated once an explicit materiality threshold is reached.
- § We agree with Ofgem's broad approach to setting a materiality threshold, but are of the opinion that the relevant range is 0.25 0.5% of revenue.
- **§** We do not believe that any trigger should be restricted to specific legislative changes and suggest that the trigger mechanism encompasses all tax legislative and case law changes that have a material impact on the quantum or timing of taxation.
- § We recognise the need for DNOs to communicate the trigger event (and quantum, as far as it is practical) to key stakeholders and Ofgem. Given the nature of taxation, we are concerned that communication of the likelihood of an event may result in misleading messages to stakeholders. We would suggest that communication is required in the year that the event crystallises.

1. Is the approach to modelling DNOs capital allowances on a common basis representative of the industry position and does it ensure that no individual DNO is materially advantaged or disadvantaged by this methodology?

We agree that modelling DNOs' capital allowances on a common basis may be representative of an industry average, but we do not agree that applying an average would result in individual DNO tax positions being fairly reflected. We also believe that capital allowance pools should represent the balances agreed with HMRC. We would suggest that the use of an average allocation does not benefit the consumer but causes distortion in the tax position for individual DNOs. In our opinion, the Regulatory Model should seek to assess the individual DNO tax liability, which will be cash settled with HMRC.

There are several reasons why a common basis may result in material divergence from an individual DNO's capital allowances and hence tax position. The primary reasons are as follows:

- § Capital expenditure for an individual DNO on a particularly large project or scheme may result in that DNO being an outlier from the average. This could materially advantage or disadvantage that DNO;
- § The basis of allocation or attribution for a specific DNO may be subject to agreement or accepted methodology with HMRC. HMRC requires each DNO to substantiate their allocation to capital allowance pools by detailed project analysis for their particular company. Industry averages have no part in this process; and
- § The treatment of certain activities can differ between DNOs and can have a distorting affect on the use of average allocations. The electrical connections activity falls into this category and Ofgem has indicated that changes will be made for the next price control recognising the contestable and non contestable elements of this. We assume that any changes will reflect the actual cash tax position for DNOs.

Ofgem recognises the company specific nature of preparing tax computations in its proposed treatment of capitalised indirect costs. We agree with this approach and are of the view that allocation of capital expenditure to tax pools should also be on a specific DNO basis.

2. Views are invited on whether the most appropriate option for the tax treatment of reopeners is the case-by-case approach.

We would support the view that the tax treatment of re-openers, for example the ESQCR and the Traffic Management Act (TMA), should be on a case by case approach given that it is sometimes difficult to pre-judge the precise nature of future changes. However, we are of the opinion that the tax effect of changes in tax legislation or the tax case law framework that trigger a materiality threshold, should be reflected in revenues for the financial year following the trigger event (see our response to Q3 below).

3. Should the DNOs retain the risk and rewards for all amounts below/above the trigger threshold; or for the entire amount rather than the excess over the materiality trigger; and what should be the appropriate timing of adjusting DUoS revenues following both single and multiple trigger events?

- § We agree with Ofgem's proposal to apply a symmetrical sharing mechanism, subject to a trigger that activates once an explicit materiality threshold is reached.
- § We also agree with Ofgem's broad approach to setting a materiality threshold, but are of the opinion that the relevant range is 0.25 0.5%. This should ensure that consideration of less significant changes is avoided but changes with a material impact are recognised.
- § We are of the opinion that the entire amount associated with the trigger event should be subject to a revenue adjustment if the explicit materiality level is reached.
- § We agree that there is a need to avoid volatility of charges and to protect consumers. We also concur with the view that any delay should not affect the DNOs' financeability.
- § We favour the option of adjusting revenues in the financial year following the trigger event and agree with Ofgem's view that the date of the trigger event is when the change came into effect. This should be subject to the condition that this is known at least three months before the year end.
- § We would suggest that if the proposed three month rule is not satisfied for a particular year, the effect of the change (including any interest adjustment) is made in the second year following the year the change came into effect.
- § We are of the view that it is extremely unlikely that there would be multiple trigger events, which would make it impractical to follow this approach.

4. We invite views on the practicality of communicating the likelihood of a trigger being activated and the methodology for it.

(i) Methodology

We disagree that any trigger should be restricted to specific legislative changes and suggest that the trigger mechanism should encompass all tax legislative and case law changes that have a material impact on the quantum or timing of taxation (in line with the trigger mechanism). We do not believe that these changes, if material, will add unnecessary complexity or would fail Ofgem's measurability criteria and we welcome Ofgem's proposal to carry out a review of this with the DNOs.

(ii) Practicalities of Communication

We have no objection to the principle of an obligation on DNOs to communicate to key stakeholders and Ofgem the likelihood (and quantum, so far as is practical) of a trigger event being activated. Given the nature of taxation, we are concerned that communication of the likelihood of an event may result in misleading messages to stakeholders. We therefore suggest that communication be addressed in the year when the trigger event crystallises. We believe that this is consistent with our proposal in Q3 above, i.e. that revenue adjustments (subject to the three month condition) should be made in the financial year following the trigger event.

Appendix 12: RAV application issues

1. Views are invited on whether there should be a separate treatment of normal pension costs and / or deficit repair pension costs and on how and if they should flow into RAV.

We believe normal pension costs should follow actual salary costs as has been the case in DPCR4. There is, however, a strong argument that deficit repair costs are fully expensed.