DPCR5 Initial Proposals

Central Networks' response

e·on | Central Networks

The photograph on the front cover was taken by Andy Icke, an Environment Advisor for Central Networks. It was taken in the Cotswolds, Worcestershire.

A: Executive summary

We have come a long way since the beginning of the DPCR5 process. Central Networks (CN) supports the aims, objectives and desired Distribution Network Operator (DNO) behaviours that Ofgem is seeking to drive through this price control review, being aligned with our strategy, embedded in our plans and supported by our stakeholders.

There are several elements of the proposals which are welcome and progressive in creating an environment that supports these principles. In particular:

- the recognition of the investment necessary to replace and reinforce our networks;
- the introduction of the Low Carbon Networks (LCN) fund to support innovation and delivery of a low carbon economy in association with the move to equalise operating costs and capital investment incentives;
- the incorporation of further positive incentives and rewards for businesses that focus on meeting their customers' needs; and
- the provision for the need to continue to recruit and train our future workforce.

However, with only relatively little time remaining, we are very concerned by both the number of key issues and errors which still remain outstanding in the Initial Proposals (IP), and the lack of transparency in the setting of cost allowances which at present create significant risks for CN in financing our activities. As drafted, the proposals are unhelpful in providing any clear indication to E.ON of acceptable future returns and risks of owning a network business in the UK. Whilst Ofgem is encouraging companies to consider the proposals "in the round", the nature of outputs means that we have to consider deliverability in terms of individual programmes and the absence of a meaningful "minded to" figure for the cost of capital makes any broader consideration impossible.

At present we have specific concerns around five key areas, together with the aspects where we have do not yet have sufficient clarity to make any assessment:

Operating cost assessment

Ofgem's opex efficiency assessment is considerably more complex and opaque than in previous price reviews. It appears to be based entirely on bottom up cost analysis which, to the extent that it is replicable, is affected by significant errors e.g. the incorrect omission of 30% of Central Networks' reported fault numbers and the Inspections and Maintenance cost driver in the West being 50% of that for the East networks despite their comparable size. Even with the correction of these errors, the quality of the regressions is generally poor. The impact of reporting differences and boundary issues inherent in the bottom up analysis is mirrored in the poor results of the statistical tests used to assess the model quality. We therefore have little confidence in the overall conclusions, borne out by the results of top down benchmarking. Such benchmarking in our view has a stronger regulatory precedent, offers at least equally credible results, suffers less from boundary issues and errors, passes the statistical tests and allows a wider view of efficiency to be taken.

Companies must be given operating cost allowances that are credible and achievable, but Ofgem's current methodology results in industry wide allowances that are 3% less than would have been generated from adopting an upper quartile company using Ofgem's 'top down' benchmarking. **The impact on Central Networks alone is some £20m p.a.** Further examples of these distortions in the benchmarking are seen through the differing conclusions for the East and West licensed areas despite fully integrated management and policies.

Fast/slow pot allocation

Whilst we agree with the fast/slow pot mechanism in principle, Ofgem's proposals on the allocations of costs to these pots would result in a £95m reduction in our revenues compared to applying the DPCR4 capitalisation rates. . This reduction will have a critical impact on the attractiveness for E.ON to invest in Central Networks in DPCR5, significantly impacting cashflows and Return On Capital Employed (ROCE). To enable Central Networks to fund the necessary investment, the Final Proposals **must adjust the current allocation by £95m to provide us with a level of fast pot allowance and hence cash flows on a consistent basis to that of DPCR4.** For customers this is value-neutral but will have one of the biggest impacts on our ability to attract the necessary investment over the DPCR5 period to maintain service and support a rapidly changing energy world.

Assessment of capital expenditure unit costs

We have a number of concerns with the unit cost benchmarking undertaken in the IP which has a significantly adverse impact on the resulting capital allowances for Central Networks. Firstly, the use of the lower of the DNO's cost and Ofgem's benchmark on an asset by asset basis introduces a systemic bias that penalises even the most efficient DNOs. To avoid this bias, Ofgem's benchmarking should be applied consistently against all of the modelled asset classes to establish an overall level of efficiency for each DNO to identify where reductions should be applied. This benchmark demonstrates Central Networks' plans are some £40m more efficient than the benchmark, rather than the £32m inefficiency that Ofgem asserts. **As a minimum, this deduction should be removed and our allowance re-instated in full, ensuring we can deliver the proposed outputs**. This would also align with the market unit cost information provided through our own 'alliance' tender process which has only just concluded. Secondly, as discussed at a recent meeting, Ofgem has also extrapolated the results of this unit cost benchmarking to our primary reinforcement costs which are done through turn-key contracts and hence not costed on the same basis. **From this meeting we believe the discrepancy has now been suitably resolved with an increase to our allowance of £19m.**

Real price effects

The risk of real price effects impacting delivery of our outputs was not recognised in the IP. Our evidence, following tendering for major parts of our investment and maintenance activities in the past few months, points to a real constraint in the specialist electrical labour market, even though general construction has seen a downturn. This reinforces our belief that CEPA has drawn unsustainable parallels between specialist infrastructure labour and the general construction market which, compounded by the forthcoming glut of UK infrastructure projects worth up to £500bn over the next 10 years, would indicate further significant real labour cost increases. Ofgem has suggested that such a risk will be easily absorbed by the IQI mechanism. However, rather than reducing risk as Ofgem has suggested, the changes to the IQI matrix create a substantial new level of exposure. **These combined effects equate to an increased exposure of almost a 0.5% change in the cost of capital, which needs to be reflected in the Final Proposals**.

Tax

Whilst the IP provided an indicative tax allowance, there are still a number of issues to resolve prior to the Final Proposals. Further specific information is provided on these issues in the main body of our response with the greatest being the use of Ofgem's modelled or DNO's forecast capital allowance pools. **To avoid the allowances being claimed twice, once in DPCR4 and once in DPCR5, which has the impact of reducing Central Networks' revenues by approximately £9m over the DPCR5 period, Ofgem must use its own modelled values.**

Key elements yet to be tackled

Addressing the points above should, in isolation, ensure Central Networks is capable of financing its future investment and activities. However, there are still a significant number of other key issues to be resolved to ensure the successful outcome of DPCR5.

Network Losses

There is still much detail to work through in terms of the way the incentive will work and how the targets will be calculated for DPCR5. Whilst we still do not believe that the form of the incentive in itself will reduce carbon, we understand the intention to also incentivise DNOs to engage in overarching settlement, billing and abstraction issues. However, we would not support the fact that this wider incentive justifies a higher RORE exposure than quality of supply or customer service. For Central Networks, the cap and floor, as proposed, allows a range of outcomes anywhere between £90m reward and £90m penalty. This range is unacceptably wide both for Central Networks and for customers, particularly given the uncertainty of outcomes based upon the new calibration. At the extremes of the range, our average customer would be paying (or receiving) around £3.60 per year in losses incentives. This would be a very significant addition to the average DUoS bill, and is comparable in size to the average initial increase in DUoS charges expected to result from DPCR5. For these reasons **we strongly favour significant tightening of the range between cap and floor. Annual caps and collars are also important to protect customers and shareholders from greater volatility in prices compared to being capped on a five-yearly aggregate**.

It is also very important that targets are set in a way that takes account of work by all parties to improve data during DPCR4, so that a fair baseline is created. This means that **Dispute Final run (DF) data must be used**. Failure to do so will create targets that will be unachievable from the outset.

Pensions

We have commented separately on Ofgem's pensions consultation but are pleased to see that the steps we have taken to efficiently manage our pension liabilities have been recognised and that there are significant structural and historical reasons why different pensions treatment in the energy sector is appropriate. In particular the presence of protected persons, which for Central Networks are:

- 88% of membership numbers at March 2007;
- 97% of liabilities at March 2007;

and the level of active members, currently estimated at only 13% for Central Networks, means that a 'one size fits all' approach is not suitable for the regulatory treatment of pensions. [We therefore **support a continuation of the pass-through arrangements in DPCR5** and do not accept that this will necessitate an adjustment to the cost of capital.

Whilst we understand Ofgem has merely maintained its DPCR4 treatment of pensions in the IP for modelling purposes, we have identified two material issues in the way the liabilities have been treated which need to be resolved and corrected ahead of the Final Proposals. Currently, the modelling **deducts the element of our deficit not attributable to the distribution business twice; this therefore needs to be corrected**. Ofgem has also, to our knowledge, not explained or justified the 'efficiency' adjustment in the level of ongoing contributions which DNOs have little control over.

Cost of capital

The lack of any clarity at this stage as to the potential cost of capital is unhelpful in communicating with and securing the necessary investment from E.ON. Whilst a desire to "market test" a range by putting PWC's views out to

consultation is understandable, the degree of uncertainty this creates makes it extremely difficult to manage our parent company's expectations about investment requirements and returns. The range quoted in the IP is so wide as to make it impossible to assess the overall package, both compared to DPCR4 or other UK and European investments. As things stand, and **given the potential levels of risk in delivering these proposals, an acceptable return has to be at least that of DPCR4** as used in the IP document.

Conclusion

UK networks now need substantial investment to replace ageing assets and start delivering a low carbon future - just as global economic conditions have made that investment uniquely hard to fund. To overcome this, it is imperative that DPCR5 delivers a package which is both good value for the customer, and clear and attractive to investors. The current proposals do not achieve this. Moreover the proposals actually introduce substantial additional risks to the delivery of DPCR5 in a more volatile and uncertain economic and political environment.

There is much work to do before we can arrive at an acceptable and fair set of Final Proposals for both customers and shareholders. We therefore look forward to constructively working with Ofgem to deliver a positive final DPCR5 settlement.

B: Behaviours, Incentives, Funds and Obligations

Question 1 *Have we introduced a set of measures that can be understood by customers and other stakeholders?*

Question 2 *Are we aiming to encourage the behaviour you consider appropriate for DNOs in the 2010 to 2015 period?*

Question 3 *Are the proposed mechanisms likely to be successful?*

On the whole we believe that many of the incentives and obligations are capable of being easily understood by customers and other stakeholders. As we have highlighted previously, many of the behaviours encouraged in the Initial Proposals align with our own strategic priorities.

We do have increasing concerns with the transparency of the cost incentives and benchmarking which are far less transparent and hence replicable than at DPCR4. Annual assessments of performance and comparability are unlikely to be easy or simple to reproduce which will be an issue for both companies and stakeholders alike, potentially increasing regulatory risk. These changes also appear totally contradictory to Ofgem's Better Regulation approach. As we have proposed, there is a need for greater use of top down benchmarking both to ensure the conclusions are more robust and are transparent and replicable throughout the review period.

We support the inclusion of a Low Carbon Network fund as a means of facilitating the move to a low carbon economy, both in developing schemes to provide connection of new technologies and innovation in the way networks will be constructed and operated. However, the current approach to cost allowances runs the risk of leaving companies with insufficient resource to be able to engage, plan and implement new and innovative ways of connecting customers and managing networks. If the cost allowances are not robust or are overly aggressive then Ofgem runs the risk of causing DNOs to continue to focus on costs and cost minimisation, rather than a more proactive and expansive role in the future.

Finally, as discussed elsewhere in our response, we are on the whole supportive of the current size and balance of incentives with the exception of network losses. Given that the incentive captures settlement errors as well as carbon reduction, we do not believe the willingness of customers to pay for such improvements is as high as network performance. At the moment, with an aggregate cap and floor over the whole price control, companies' and customers' exposure is equivalent to that of network performance which is not borne out by the customer surveys. As a result, we believe that the losses incentive should be reduced to reflect the broader remit, or as a minimum should be capped at a lower level on an annual basis.

C: Environment

C1: Low carbon networks fund

Question 1 *Do you agree with our proposals for a new mechanism to encourage DNOs to develop their role in the low carbon economy?*

Question 2 *In particular, do you agree with:*

- *The proposed size of the funding?*
- *The proposals for discretionary rewards?*
- *The two tier structure?*
- *The proposals to recover Tier 2 costs over a five year period?*
- *The measures to mitigate DNO risk?*

Question 3 *Do you think we have adequately balanced the DNOs and customer risk?*

Question 4 *Do you agree that DNOs should be allowed to use any benefits accrued from the project to cover their contribution (minimum 10 per cent) to the project funding, or should the direct benefits be subtracted from the project cost before the DNO contribution is calculated, so that the DNO always contributes at least 10 per cent of the project cost?*

Question 5 *Do you agree that the funding should be provided on a use it or lose it basis, and should the Tier 2 funding be ramped over the period?*

Question 6 *Do you consider that this mechanism will achieve our stated objectives?*

Central Networks strongly endorse Ofgem's reasoning and intent behind the introduction of the LCN fund. The transition to a low carbon economy will have significant implications for DNOs. It is essential that Ofgem introduces a mechanism in DPCR5 that will allow DNOs to develop different ways of working to efficiently service a low carbon society. The new mechanism needs to cover the costs in three areas. Firstly, the cost of people to engage with customers and stakeholders, develop and plan innovative solutions and subsequently implement them. Secondly, the cost of lighthouse demonstration projects to prove new methods. The third and final area is the cost transferring these new methods into business as usual. The Environment Working Group discussions on this topic have reflected this sentiment and helped to develop the proposals for the LCN fund. It is however appropriate to note that the proposal as published in Initial Proposals is far from complete. There remains a significant amount of work to do before the Final Proposals. The following points identify a range of features of the proposed incentive which require further development.

The scale of the proposed incentive is appropriate to fund larger demonstration projects trialling innovative solutions to network problems.

At least a proportion of the fund should be within the managerial control of the DNO (subject to compliance with the proposed detailed guidelines). This allows the DNO to manage commitments to customers and innovation partners without reference to Ofgem. The proposed Tier 1 appears to satisfy this requirement.

The philosophy behind the Tier 2 proposal appears contradictory to the sentiment that learning from the projects must be shared by DNOs. Introducing competitive applications is not readily compatible with shared learning, and already the propensity for DNOs to share ideas is reduced.

The scrutiny of Tier 2 submissions for acceptance should be by an independent expert panel. Ofgem should be represented on the panel but should not have disproportionate influence on the decisions made.

The proposal's approach to risk and reward needs to be more clearly explained. From the description given in the Initial Proposals it is hard to conclude that there is a financial incentive to DNOs to undertake this kind of project. The difficulty in defining the 'benefits' of a project is the first stumbling block. In some cases the benefits of innovation are seen by the customer (for example, a lower cost connection) rather than by the DNO. It certainly seems that any benefits achieved should be allowed to cover any contribution that DNOs have made to a project.

For projects which do not achieve their aims, the proposed mechanism whereby a DNO can apply for additional project costs or 50% of benefits not achieved, would seem not to remove uncertainty. It is difficult to see how this is a risk reduction as Ofgem retains the right to disallow costs.

The suggested discretionary reward mechanism is too subjective to be considered as a significant financial incentive for innovation. A more mechanistic approach with more obvious markers of success is needed before this can be viewed as an adequate reward for a higher risk project.

Ofgem has received advice on the legality of the proposed funding mechanism, whereby customers of a DNO will be required to pay for work carried out by a different DNO. This advice should be shared with DNOs so that it can be considered by them.

It is assumed that the costs of preparing bids for Tier 2 projects will be funded from Tier 1. The rationale for limiting DNO groups to two bids per year is not clear.

The timetable for developing project guidelines and submitting Tier 2 bids has not yet been developed. Ofgem needs to clarify its expectations, particularly for the first year of DPCR5.

The proposal refers to intellectual property rights which may arise from successful projects. Ofgem suggests that GB customers will have funded development and are entitled to a share of earnings from IP. This scenario is highly unlikely. Manufacturers who enter into partnership with DNOs on these projects are likely to have spent significant sums on the development of new technology products. Any attempt to reduce the value of IP earnings is likely to be a barrier to partnership and Ofgem should not implement such measures.

It is obvious that further development of this incentive is required before Final Proposals and we look forward to contributing to shaping this important mechanism.

C2: Provision of Information to Distributed Generation

Question 1: *Have we correctly captured the customer's information needs?*

Question 2: *Do you agree with the scope of proposed licence obligations?*

Question 3: *Do you agree with our proposal to request DNOs to commit to a strategy for information provision?*

Central Networks welcomes Ofgem's proposals with respect to the provision of information to distributed generation (DG) customers. Ofgem has correctly identified that there are a number of different types of DG customer with differing information needs. We have already started to develop tools to meet this requirement in recognition of the anticipated increase in DG in response to climate change concerns and changing UK energy policy.

Although work has started on some relevant tools, it is clear that there is still some uncertainty on the precise needs of the different customer groups. The proposal to mandate provision of an information strategy is therefore appropriate because it allows further consideration of customer needs and gives each

DNO the scope to be innovative with the service it provides with reference to its specific mix of customer types.

There is a significant cost to the development, implementation and ongoing operation of tools for providing network information (such as heat maps) or on-line connection estimates. We assume that development and implementation of such systems will be eligible for funding via the tier 1 of the Low Carbon Network Fund (LCNF), and once rolled out the efficient ongoing costs will be funded via additional allowance to network operating costs.

C3: Distributed generation incentive framework

Question 1 *Do you agree with our proposal to retain the DG incentive framework largely unchanged from DPCR4, and do you have any comments on the detail of our proposals?*

The proposal to retain the DG incentive framework largely unchanged from DPCR4 is appropriate. During DPCR4 a much lower volume of DG connected than was forecast, and therefore insufficient evidence is available to draw any conclusions on the merits of the incentive mechanism. DPCR5 forecasts are highly uncertain. Consequently there appear to be no grounds for significant changes to this incentive.

C4: Use of system charging to pre-2005 connected Distributed Generation

Question 1 *Do you agree with our proposal to terminate the blanket exemption from use of system charges for pre-2005 connected DG, with effect from 1 April 2010?*

In principle we believe these generators should pay use of system charges in the same way as more recently connected generators. This will ensure that the economic signals contained in the charges are felt equally by all, thus facilitating efficient outcomes and non-discrimination.

We are concerned however that there is currently confusion about both what is going to happen, and when.

Our proposal is that HV and LV connected generators and EHV connected generators should be treated differently in the short-term:

- pre-April 2005, HV and LV connected generators should pay charges (or receive credits) with effect from April 2010. This coincides with the implementation of the Common Distribution Charging Methodology (CDCM), which will be the longer-term charging methodology for HV and LV customers;
- pre-April 2005 EHV connected generators should not pay charges (or receive credits) until April 2011, when the EHV Distribution Charging Methodology (EDCM) will be implemented. Again this coincides with the start of the longer-term methodology for EHV customers.

The advantage of delaying charging for EHV connected generators is that potentially very different charges – arising from cutover between the current methodology and the tariffs required under the new EDCM requirements of our licence – will not impact these customers. If charges were introduced from 2010, EHV connected generators might pay large positive charges for one year (while HV and LV generators enjoyed

negative charges), followed by very different (in many cases negative) charges in subsequent years. This does not seem sensible or appropriate.

In anticipation of the possibility that generators are successful in pushing for rebates of connection charges / operation and maintenance charges for connections made under pre-April 2005 rules, clarity is needed about how such rebates would be funded and treated.

C5: Transmission exit charges incentive

Question 1 *Do you agree with the proposed hybrid approach for the regulatory treatment of transmission exit charges?*

Question 2 *Do you agree that in setting the scope of the incentive we targeted the appropriate cost items?*

Question 3 *Do you agree with the level of exposure under the proposed sharing factor?*

Central Networks welcomes Ofgem's proposal to retain the existing cost pass-through mechanism for transmission exit charges which arise primarily from decisions by the Transmission Owner (TO). However proposals to incentivise the transmission exit charges which arise from new load related investment fail to recognise the range of uncertainty involved and the extent to which DNOs can control subsequent costs.

The proposed incentive mechanism requires DNOs to make a forecast of anticipated exit charges. In the first instance, a network need may have been identified but not a specific solution. A range of options may need to be evaluated before the optimum solution is identified. This is particularly likely if the network need is forecast to occur in the final two years of a price control period. National Grid Electricity Transmission (NGET) provides accurate exit charges only when projects are close to their conclusion. Forecasts of project costs at the time of the price control review, and the associated transmission exit charges, are consequently highly uncertain.

Once a DNO has submitted its exit charge forecast, Ofgem will carry out a further review of the data, already recognised as highly uncertain, and conclude on an ex-ante allowance, which may or may not be the same value as the DNO forecast. This treatment adds further uncertainty.

The DNO, having persuaded NGET of the network need, then agrees the optimum solution with NGET and requests that work is carried out. At this point the industry agreements oblige the DNO to pay the outturn charges related to the work, although the DNO has no control over the project costs.

The proposed incentive then takes the difference between a highly uncertain forecast, second guessed by regulatory opinion, and outturn costs over which the DNO has no control, and applies a sharing factor to result in an almost arbitrary penalty or reward for the DNO. It is difficult to see how this proposed incentive scheme acts in the best interests of customers as the outcome is not driven by DNO controlled actions.

The existing cost pass through treatment of transmission exit charges should be retained for DPCR5. If Ofgem introduces this new proposed incentive then additional risk is introduced into the price control settlement. This increase in uncertainty should be reflected in a higher cost of capital.

C6: Losses incentive

We have three significant issues around the losses incentive as proposed:

- the cap and floor arrangement is too loose and will expose both customers and DNOs to excessive risk;
- the use of 'reconciliation final' (RF) settlements data to set targets, rather than the better cleansed 'dispute final' (DF) data, is likely to further undermine the targets and DNOs' ability to attainment;
- the withdrawal of protection against adverse losses impacts associated with some new distributed generation is inappropriate.

Cap and floor

For Central Networks, the cap and floor, as proposed, allows a range of outcomes anywhere between £90m reward and £90m penalty. This range is unacceptably wide for both Central Networks and for customers. At the extremes of the range, our average customer would be paying (or receiving) around £3.60 per year in losses incentives. This would be a very significant addition to the average DUoS bill, and is comparable in size to the average initial increase in DUoS charges expected to result from DPCR5. For these reasons we strongly favour significant tightening of the range between cap and floor.

Part of the desired reduction in risk for both Central Networks and for customers could be achieved by reducing the £/MWh incentive value by removing the shadow price of carbon (SPC) from the mix. This would be consistent with the likely 'carbonless' nature of loss reductions which an output incentive will drive.

Target setting

There is clear evidence that settlement data was adversely affected by data errors during the DPCR4 period. In particular, the admission into settlements of excessive 'estimated annual consumption' (EAC) and 'annualised advance' (AA) data lead to material overstatement of customer terminal volumes. This overstatement would drive artificially low losses targets under the proposed methodology. Excessive EACs and AAs have been the subject of a long running settlement dispute, and measures to eliminate these and similar errors through DF runs have proved largely successful. The DF runs are corrected and authorised for use in settlements by the Balance and Settlement C Code (BSC) Trading Disputes Committee, and are the best available estimate of actual consumption.

Central Networks will use DF data to report losses for the DPCR4 period, and it would be consistent also to set the DPCR5 targets using the same DF data. It is important that settlement errors are not allowed to distort targets or limit DNOs' aspirations, and we therefore strongly favour the use of DF data for incentive target setting for DNOs where this is materially different to RF. In our view the additional delay introduced by taking account of DF would be more than compensated for by more accurate and appropriate losses targets. Alternatively, RF data could be used for target setting for all DNOs, but with appropriate adjustment for those DNOs where DF is materially different to RF. Such adjustments could be based on the level of difference between RF and DF data for those periods where DF data is available. We note that Ofgem was comfortable with company-specific adjustments to targets for DPCR4, when historic data was altered for three DNOs.

Evidence contained in Appendix I of the Engage Consulting report on losses suggests that material differences between RF and DF affect a limited number of DNOs, and this seems to support the case for treating these cases differently.

Protection against DG losses

The use of our networks is changing fundamentally, and it is inappropriate for DNOs to be penalised for this via the losses incentive. The possibility that new DG might adversely impact network losses was anticipated and specifically accommodated in the DPCR4's losses mechanism. More remote, often 'green', generation is

likely to come on stream in future, and network losses (but not necessarily carbon) will increase in some cases. Recent experience confirms the potential scale of such impacts, and underlines the need for this protection to continue.

Question 1 *Do you agree with our proposal to provide explicit funding for justified low loss investments to provide direct recognition of the investment?*

Yes, however any related adjustments on losses targets needs to take into account the timing of such investments and the benefits they accrue. Clearly it would be inappropriate to adjust losses targets for the full period of DPCR5 for an improvement that was not expected until mid way through the period, or one who's full effect on losses took some time to be felt.

Question 2 *Do you agree with our proposals (common reporting, reporting lag) to address the issues associated with using settlement data to measure losses?*

Common reporting will help with the consistency of loss reporting amongst DNOs whilst a reporting lag will remove the volatility inherent between the start and end of the settlement process. However a reporting lag will do nothing to address the volatility in settlement error and the DNOs and consumers will continue to be exposed to these errors which in our view will be the main driver of performance during DPCR5. We maintain our strong concerns with the use of an output based approach and believe that much tighter caps and collars should be set to limit the effect of settlement error on end consumers and DNOs.

In terms of the target setting, it is unacceptable to use RF data for target setting when more accurate data is available from the DF settlement run for some DNOs including Central Networks. In the Central Networks areas, suppliers continue to use the DF run to improve the accuracy of settlement data (and therefore losses data) and the corrections to the data that we have experienced between the RF and DF data is significant. For the first two years of DPCR4 corrections have resulted in an average reduction in units distributed (and hence an increase in losses) of 120 GWh in Central Networks East and 51 GWh in Central Networks West. The Metering Point Administration Numbers (MPANS) associated with these data corrections will have corrected data entering settlements from the beginning of the DPCR5 period and therefore if it is consistency that is desired, then the targets for DPCR5 must be based on the latest settlement data available from DPCR4, which for some may be the DF data.

This approach is also more consistent and equitable, to the extent that the targets for DPCR5 are based on the same data that is driving the rewards for DPCR4. Clearly, if a DNO experienced large positive data corrections between the RF and DF settlement runs in DPCR4, it would be inappropriate and unfair to consumers for that DNO to benefit from the reduced losses caused by the DF data through the DPCR4 losses mechanism whilst benefiting again through the DPCR5 losses mechanism by virtue of the high target that would result from using the 'inaccurate' DPCR4 RF data. The converse is equally valid and it would be unacceptable to Central Networks for targets to be based on RF data. Valuing losses at £60/MWh converts the inaccurate and inconsistent target setting proposed (using RF data) to an exposure to Central Networks of £10m per year for the entire DPCR5 period. Inappropriate and unachievable targets would limit DNO activity and hence restrict the benefits that might be driven by more appropriate targets.

Question 3 *What are your views on our proposals for a common reporting method and where we have identified options, which do you prefer?*

We support the use of a common reporting method and our preference would be for the hybrid method of calculation. We believe this method carries less risk of calculation error.

Question 4 *Do you agree with our revised losses incentive value and our proposal to retain the rolling retention mechanism?*

We believe the SPC should be excluded from the incentive value, on the basis that this would be consistent with the likely 'carbonless' nature of loss reductions which an output incentive will drive.

As we have previously pointed out to Ofgem, the rolling mechanism only works if losses are attributed to the year in which they occurred. Ofgem's proposed approach for DPCR5 addresses this issue. However, there is still a lack of clarity on how Ofgem will address this for DPCR4.

Question 5 *Do you agree with our proposals for a common treatment for substation energy usage, where the substation usage is registered with a supplier so that they pay for the electricity consumed?*

We agree with this proposed approach however we believe that there should be no opportunity for windfall gains or losses in this area with respect to any necessary adjustments to targets. These adjustments should be based on the billed consumption for this energy usage through the DPCR5 period.

Question 6 *Do you agree with our proposals to recognise and reward improvements to the losses measurement?*

We do not believe that a specific reward for improvement to losses measurement is appropriate. The reward for simply improving measurement is implicit in the incentive itself, although we accept there may be occasions where a penalty is incurred as a result of improved measurement. Therefore, genuine innovations that contribute towards carbon reduction should be rewarded through the Low Carbon Networks Fund.

C7: Treatment of DPCR4 losses rolling retention mechanism

Question 1 *Do you agree with our proposal to leave the DPCR4 losses incentive open for the first three years of DPCR5 until the settlement corrections are complete? What are your views on our proposal that the absolute losses performance will be exposed to the DPCR4 rolling retention mechanism?*

In principle, we believe that the losses incentive should remain open, with any revision to DPCR4 losses taking place in DPCR5 going back into the year in which the losses were incurred. Previous working versions of the rolling mechanism provided by Ofgem did not address this issue correctly resulting in the potential for windfall gains or losses and there is still a lack of clarity on how Ofgem proposes to address this issue.

Question 2 *Do you consider that the proposals for closing out the DPCR4 rolling retention mechanism have merit, and if so, how should we manage the uncertainty?*

We are not sure where this concept has come from and need further details of what Ofgem is proposing to comment further. However if, as Ofgem seems to suggest, there is to be an ex-post correction to any agreed buy out or bid then we would question the purpose of such a scheme in the first place, as it would not reduce any of the uncertainty it claims to and would simply involve more work.

C8: Business carbon footprint reporting

Question 1 *Do you agree with our proposal for BCF reporting requirements?*

Question 2 *Do you agree with the proposed guidance for the BCF reporting methodology?*

Question 3 *Do you agree with our proposal to rely on a reputational incentive only (through publication of a league table)?*

It is appropriate that DNOs should report their BCF. The scope of that reporting should take into account both the materiality of the emissions and the costs of the reporting process to ensure that the costs of reporting are proportionate to the potential benefits of emission reductions.

The initial analysis of the reporting exercise on 2008-09 data raises a number of questions about the scope of existing reporting by DNOs. It seems likely that the proposed guidance for the BCF reporting methodology will require some modifications when the results of the reporting exercise are investigated more fully.

As BCF reporting is in its infancy neither accuracy nor consistency of method have been established. Consequently it would be inappropriate to introduce a financial incentive. The publication of a league table is appropriate once a common and consistent reporting framework is in place. Ofgem and the DNOs should review progress towards this aim through the DPCR5 period and agree that this aim has been achieved before deciding on a baseline year.

C9: Undergrounding in Areas of Outstanding Natural Beauty ('AONBs') and National Parks mechanism

Question 1 *Do you agree with our proposed amendments to how the undergrounding allowance is formulated?*

Question 2 *Do you agree with our proposed approach to undergrounding projects not completed by the end of DPCR4?*

Central Networks support the approach proposed to formulate the undergrounding allowance and the overall shape of the incentive scheme. We note the discretionary nature of the incentive and look forward to continuing to work with our established stakeholder groups to develop further relevant projects.

D: Customers

D1: Connections incentives and obligations

Question 1 *Do you agree with the scope, timeframes and the level of penalties proposed for the guaranteed standards regime?*

Central Networks supports the principles of the additional service standards in their intentions to improve levels of service for connections customers which is aligned with our own strategy. We do have some concerns over the levels of complexity which the standards will impose into the connections process and the potential for a reduction in flexibility for the customer and therefore believe there is work for us to do as an industry to further develop these standards.

This may especially be the case in the area of the delivery of the works where the required rigidity of process could cause frustration for customers and be perceived as the DNO becoming inflexible.

Further clarity is needed over the proposed standards before a full impact assessment can be made and we support the additional work required to formulate the detailed guidance, exemptions and reporting. Development of the guidance, rules and exemptions will be vital in ensuring the standards are practical and achievable – we believe the standards need to penalise poor service to the customer caused by act or omission of the DNO. s The standards should therefore reflect what is both controllable by and achievable for DNO.

It will also be important that both the customer and the DNOs have equal understanding of the standards and the required minimum performance levels. Without this common understanding, the customers' expectations will not be managed and they may also receive differing interpretations across different DNOs. Therefore a single set of business rules and exemptions along with guidance documents for the customer will be a key requirement.

The step change increase in recording and reporting that will be required for the standards regime will require a corresponding level of system and process development of around £500,000, the cost of which will need to be recovered and will ultimately be passed on to the customer. This development will take time to implement and will not be able to start in earnest until we have a firmer view of the final regime's detailed rules and guidance. With this in mind we propose that a trial period be put in place initially, at the beginning of DPCR5, to allow us to be fully up-and-running in both the performance to the new standards and also the reporting requirements. The trial period's length would need to be twelve months to allow new projects to progress through the categories of the standards.

With the timescales for setting the details of the regime we believe it would be necessary to allow a trial period for performance reporting without penalties and have an interim review of the regime before a full 'go live'. This will afford a more acceptable level of the risk where the standards regime has been set at a practical and achievable level with no unintended consequences for the customer or DNO.

We also believe that the trial period would be important for the unmetered connections standards to allow the development of understanding between DNOs and the local authorities and other unmetered customers.

For both the unmetered and metered connections standards, the proposed trial will allow for the sharing of best practice between DNOs and feed back from customers to ensure the regime delivers on its aims.

We are keen to understand how the standards will apply to work in progress on existing connections projects starting before DPCR5. This will have an impact on the scope of any system changes and the reporting requirements and we would suggest that this added complication would be another strong reason for there to be a trial period to allow any such complications to be worked through. We would propose that

the new standards are only applied to new applications received from April 2010, from the beginning of the proposed trial. We believe that this would be more practical than a migration for the recording and reporting purposes. We would, however, still apply the same level of service to works already in progress since we will be proactive in improving all our processes to ensure we deliver as a minimum the service required by the standards.

Question 2 *Should we develop a mechanism to ramp up the level of the proposed penalty payments?*

The proposed penalty regime already has a level of ramp up built in to the majority of the standards in the 'per day of failure' payments. This mechanism ramps up with increasingly poor performance and maintains the emphasis on completing the required work as soon as practicable. We therefore do not believe that further ramp up of the level of penalties is required and would add an unnecessary further level of complexity and risk to the regime in terms of reporting, calculation of penalties and understanding for the customer.

Since delays and missed standards will inevitably have a knock-on effect to other projects' standards in the work programme, the proposed 90% overall standard is also an additional driver to ensure that we aim for a right-first-time service level and further supports that the mechanism to ramp up the penalties is not necessary.

Question 3 *Should we cap the penalties that apply to each of the proposed standards?*

We believe that there should be a cap on the penalties to avoid any unintended consequences of such a significant change in regulation of connections. We believe the caps should not be any higher than in the Gas industry standards connections business rules and that the maximum liability should be set at the contract sum.

Whilst the majority of customers will want the work completed as quickly as possible and as promised, having caps in place will also limit any possibility of a minority of customers gaming with the standards to receive substantial penalty payments.

Question 4 *Should we apply in aggregate a 90 per cent performance target to apply to the standards and measure this on a quarterly basis?*

We believe the performance target should be aggregated across all standards to measure overall performance since the penalty payments maintain accountability to the individually affected customers.

If performance in each category is used as a measure for the licence condition there is a risk that categories with low volumes will carry more weighting for each failure than for those in high volume categories.

Quarterly reporting may be necessary to monitor performance during any trial period and will also be required for demonstrating performance in the competition tests. This will however create an issue around seasonality of volumes and the effect the resulting peaks and troughs may have on quarter to quarter performance. This will need to be considered when setting the reporting requirements.

Question 5 *Do you agree with our market segmentation strategy for metered and unmetered connections? Are there any segments other than those identified that should be exempt from earning a margin?*

We believe the market segmentation reflects those areas of the electricity connections market which are attractive and unattractive to competition. Together with the standards regime they also importantly reflect that different customer types have differing needs and requirements.

It should be noted that we do not currently categorise connections in these ways, either for our internal purposes or for regulatory reporting. Therefore we will need to carry out wide ranging system and process developments in order to capture projects in these categories together with a migration exercise for works already in progress if this is to be required. It will therefore be necessary for us to recover reasonable costs of implementation which will be passed on to the end customer.

Question 6 *What are your views on the proposed level of regulated margin and is there any further evidence we should take into account in setting the level of regulated margin?*

We welcome the proposed treatment of costs for sole use connections assets as non-relevant excluded services and the ability to earn a regulated margin on the direct cost of these connections. We do however have some concerns around the complexity of operating this methodology for pricing connections projects and the subsequent recording and reporting of costs.

We would like to seek further clarity on whether the regulated margin and excluded service treatment only applies to sole use connections costs on projects with only sole use works, or also on sole use costs on projects where there is also an element of shared use works. We also want to clarify that the margin and treatment only apply to the contestable element of the sole user connections costs.

By only allowing the margin on the direct costs of sole use connections, this will create an additional complexity in setting prices for estimating connections costs and also to allocate customer contributions accordingly particularly where there may be an element of under or over recovery at a project level.

We are interested to understand whether competitive connections providers believe the proposed 4% regulated margin on the direct cost of sole user connections will be large enough create the intended headroom to stimulate further competition. To reduce the level of complexity and cost of operating this methodology, we would propose that the regulated margin would be applied to the total costs of the connections work rather than only the direct costs. This would not only simplify the application of the margin but also create additional headroom for competitors. The proposed claw back mechanism should ensure that DNOs do not gain by this additional level of margin despite poor price and service or low levels of competition.

Question 7 *Do you have any comments on the scope of the proposed competition tests?*

There is still a large amount of work to be done to finalise the details of the tests and the necessary reporting requirements. Therefore it is difficult to assess the final impact on us or the resource and system change requirements. Due to the severity of the consequences of non-compliance, it is essential that we clearly understand the measures of the tests and the criteria against which will be judged for the more subjective elements of the tests.

We believe the principles of the tests and the three main categories are appropriate to what the tests set out to achieve – namely ensuring DNOs do not act as a barrier to competition and demonstrating this in a measurable way.

We agree with the principle and think it important that market share should not be the sole measure of a DNO's openness towards competition in connections. From our understanding of the pass / fail mechanism, we would strongly agree that this recognises that although the DNO may not lose significant market share, it may still fully support and facilitate competition and also deliver the level of service connection customers expect and can pass by meeting the requirements of the Legal test and the Price and Service test.

Question 8 *We invite views on the relative weighting of market share compared to the price and service tests? What level of lost market share would be appropriate to deem the market competitive?*

We believe that a Herfindahl-Hirschman (HHI) score of 1000 to be far too low to move to by the end of 2013 from current levels. With levels of around 50% market share for Gas Distribution Networks (GDNs) in the Gas industry and more of the works classed as contestable, it would not seem reasonable to expect greater levels of competition in electricity connections.

The current economic downturn has and will continue to impact on competition in connections and will therefore affect levels at least during the start of DPCR5. This impact is not in the control of the DNOs and needs to be taken into account when setting the levels of market share for the competition tests.

With reference to our response to question 7 above, we support the split of the tests between price and service and market share. It is within the DNO's control to deliver the service required by its customers and to act in the spirit of competition, being open and not a barrier. Conversely, loss of market share to competitors is not fully in the DNOs control, it is dependent on third party activity and as such should not carry the risk and threat of the DNO being referred to the Competition Commission without the ability to demonstrate the customer service performance and openness to competition.

D2: Broad measure of customer satisfaction

Question 1 *Do you agree with the proposed scope of the broader measure?*

Question 2 *Do you agree with the revenue exposure and the incentive weightings proposed for each element?*

Broader Customer Satisfaction Measure

We welcome the introduction of the broader measure of customer satisfaction and agree that a two year "bedding-in period" would allow the refinement of a measure that is meaningful to our customers and will allow sustainable, positive actions. We appreciate Ofgem's comment that the intention is to discontinue the current telephony survey or amalgamate it into the broader measure by April 2012. In the case of the latter, this will obviously require some clarification and we would welcome the opportunity to work it through and understand how this would work in practice.

Customer Satisfaction Survey

We are aware of a number of issues that are still being considered as part of the Consumer Issues Working Group (CIWG); for example, the surveying of customers who were given an automated message will require significant changes in the way the current survey is undertaken. This practically would mean giving the customer the information about the survey they are being asked to undertake, giving them an option to 'opt out', and validating that they were the person who received the automated message etc. All of this will add complexity and cost to the survey process which needs to be kept in proportion to the additional value gained by surveying these customers. In simplistic terms it is best to ensure that whilst the process widens the view of customer satisfaction that the data gathering process does not become overly burdensome. An overly complicated process risks not only incurring disproportionate cost but may also be slow.

We feel that customer feedback is most likely to add value when it is sought quickly, otherwise the customer's recollection will fade, and the request to participate in the survey may well have a negative outcome.

We agree with the intention to balance the views of different customer groups within the satisfaction survey. We would like further information as to how the survey will balance the various results from the different customer groups to avoid skewing the results. The appropriate sample size will also require definition.

We fully support the introduction of an advocacy approach, but agree that the survey will require careful wording. Putting ourselves in our customers' shoes shows us that at times they still struggle to understand the distinction between distribution (as a monopoly business) and supply. We therefore believe that asking respondents whether they would "recommend" the DNO is not appropriate. We support an alternative approach where customers would be asked how they feel, or whether they would speak highly or critically of the company, following their recent contact with the DNO.

Complaints Metric

The complaints metric within the measure should be aligned to the information that is collected as part of the complaints escalation process. Similarly there will need to be further development such that definitions are constant across DNOs. There is currently some inconsistency in the approaches used by DNOs in data gathering and interpretation with regards to complaints and customer claims, for example. To ensure comparability it would be useful for all DNO complaint numbers to be published. It would also be useful for DNOs to be able to compare these by the nature or area of complaint e.g. interruption notification, call handling, work on site, site staff etc.

Ofgem has put forward some suggestions as to how the complaints could be categorized in terms of time to resolution and referrals to Ofgem. Ofgem also refers to repeated complaints and this requires further definition to distinguish whether this refers to repeated complaints about the same incident or from the same customer but relating to separate incidents, for example. We also agree that aligning the complaints recording across DNOs will present some challenges. Extending the complaints recording outside those areas covered by the current complaints handling standard will introduce new reporting requirements, therefore early agreement on the attributes to be reported is required to enable DNOs to introduce new business processes. We appreciate and welcome the fact that Ofgem will continue to work with the CIWG in order to address these issues such and to refine the reporting template.

Customer complaints are, however, a very small proportion of the total customer interactions. Therefore even allowing for the high levels of inconvenience experienced by these customers, we consider the financial weighting on the customer complaints element somewhat heavy. We therefore consider a value of +0.3 – 0.4% to be more appropriate. We suggest that the additional weighting be added to the customer satisfaction element, which would become +0.5 –0.6% to maintain the overall incentive strength. Another reason why the lower weighting would be appropriate is that DNOs are already exposed to financial penalties in relation to customer complaints under the new standard, for example from incurring costs associated with Ombudsman referrals. Too high a financial penalty could incentivise DNOs to create the illusion of resolved complaints by making payments to customers. We do not believe this is in the long term interest of customers.

Stakeholder engagement

In terms of the stakeholder engagement element, there needs to be clarity around the attributes and measures of success or failure and a process in place that will ensure consistency between DNOs. Determining a consistent way of measuring and evaluating different responses to different requirements will be a key element to this measure. Such clarification is needed to ensure that the survey captures not only what engagement DNO's have undertaken, but also the method by which the DNO has done so, as well as the success, impact and scale of delivery of the DNOs efforts, as perceived by the stakeholder(s) in question. We believe that stakeholder surveys or interviews should be spread out through the year to avoid DNOs treating stakeholder engagement as an annual event, but rather adopting a more embedded and sustainable approach.

Survey Feedback

We agree it is sensible to calculate the associated financial penalty or reward annually. However, in order to provide timely feedback to the DNOs, we believe that the results of the customer satisfaction survey and any complaints metric should be published on a monthly basis, as per the results of the current telephony Information and Incentives Scheme. These results should be seen in the spirit of continual improvement. The

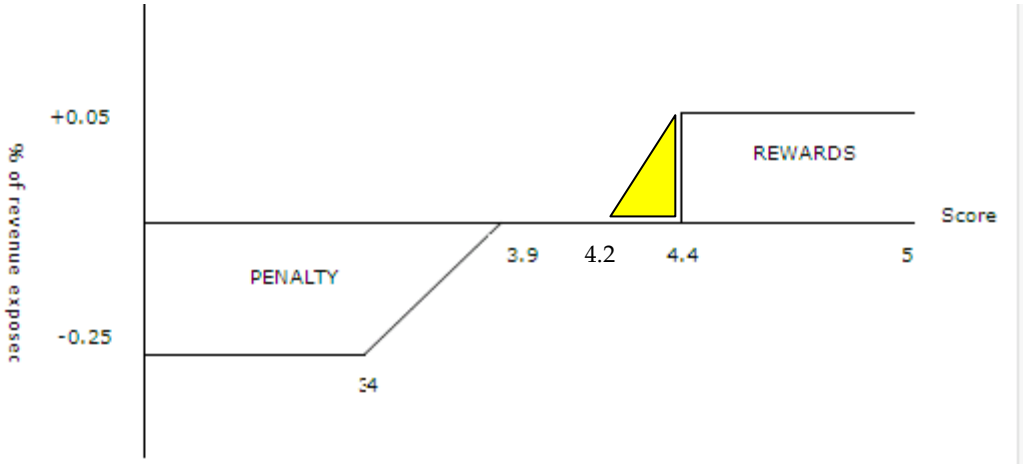
Stakeholder Engagement element of the measure does not need monthly results but the content and frequency of feedback in this area needs to be determined.

D3: Telephony incentive scheme

Question 1 *Do you agree with the proposed improvements to the telephony scheme?*

Question 2 *Do you agree with our proposals and methodology for recasting the reward and penalty thresholds?*

We agree with the proposed changes to include unsuccessful calls and streamline the attributes used within the measure. We agree that this will require the reward and penalty limits to be recalculated but we believe that the incentive would be better balanced if there were an additional upside incentive. However all DNOs are liable to the potential penalties and given that the penalty is five times that of the reward, the imbalance between penalty and reward is excessive. We propose the addition of a graduated reward element as shown by the yellow triangle on the diagram below:



A sliding upward scale of this nature would provide an incentive for improvement for those DNOs currently within the dead band, without lowering the overall upper threshold (4.4) whereby the full reward (+0.05%) can be achieved.

D4: Worst served customers

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

Whilst we absolutely support the intent of improving service for worst served customers, we would like to stress our concerns that the proposed mechanism will drive DNOs to only make improvements where it is relatively easier to meet the ex-post funding assessment. Therefore it will not provide benefits for those customers where network improvements are more costly and difficult to achieve.

The proposed mechanism introduces a great deal of uncertainty as demonstrable improvements need to be evident before capex allowances can be claimed. This has the unintended potential to encourage investment in schemes where it is more certain that the required improvements can be achieved, and as such may lead to investments in the 'slightly poorly served but easy to make improvement customers' rather than those

truly worst served. We therefore suggest that the degree of regulatory control over this relatively small investment (of on average £600k pa per DNO) is somewhat excessive and may actually reduce its impact.

We reiterate that as this is the first time such investment 'allowances' have been provided then DPCR5 should be a period of trial and understanding. This will enable DNOs to attempt different approaches to improve customer service which would provide a better range of knowledge and experience to determine best practice. We therefore suggest that ex-ante allowances should be provided and DNOs be expected to demonstrate that investments have been targeted at worst served customers, with an aspiration to achieve 25% improvement, but without the absolute need to achieve this so as to not restrict the scope.

Question 2 *Do you agree with the level of the proposed cap per benefiting customer? If not, what level do you believe is appropriate?*

Limiting the cap to £1000 per customer will restrict the scope of works that are possible, further driving DNOs to address those circuits where it is inexpensive to achieve the performance improvements, which may not be those with worst served customers. We accept that the amount per customer should not be unlimited, but it should be large enough to allow a wider scope of works whilst excluding extremely costly solutions. A workable value would therefore be around £2000 per customer.

D5: Interruptions Incentive Scheme (IIS)

Question 1: *Do you agree with the proposal that any required improvement from current performance level should be funded by shareholders?*

The absence of ex-ante allowances for quality of supply introduces a financial disadvantage for those DNOs required to make performance improvements. Shareholders will either suffer penalties or incur financial costs to avoid the penalties (where investments are made). This means that there is a systemic negative bias for those DNOs expected to make improvements.

Where DNOs do not need to make performance improvements, the IIS scheme is symmetrical where investment decisions are driven purely by incentive rates for outperformance, but conversely it is asymmetrical where companies are expected to invest just to remain at a neutral point (without an allowance being provided to bridge performance gaps).

There are two potential solutions to this negative bias:

- Set targets at current performance levels for all DNOs (with a flat target profile) and allow improvements (outperformance) to be driven by the incentive rates determined from customers' willingness to pay.
- Provide ex-ante allowances for investments to bridge performance gaps (allowing DNOs to remain neutral under the IIS scheme) such that the incentive rates then drive further investment decisions that would lead to outperformance.

Question 2: *Do you agree with the approach to setting pre-arranged allowances?*

The Electricity Safety, Quality and Continuity Regulations (ESQCR) re-opener approach provides a simple and reasonable mechanism to benchmark pre-arranged forecasts based upon impact per £ investment. The introduction of a pot that can be utilised throughout the DPCR5 period providing flexibility for work programmes is welcome, but the difference in treatment for penalty and reward should be made more consistent; either both should be subject to the annual cumulative assessment or the end of period evaluation, not a mixture as is currently proposed.

Question 3: Do you agree with the proposed levels of revenue exposure and incentive rates?

Provided that the systemic negative bias discussed in the response to question 1 is resolved, we believe that the enhanced incentive rates will continue to provide a strong incentive to maintain, and where financially efficient, improve network performance. Revenue exposure should be maintained at the 3% level to provide an appropriate balance of risk between companies and customers.

Question 4: Do you agree with the proposed refinements to the exceptional events mechanism?

We welcome the inclusion of asset failures within the one-off exceptional event mechanism providing some protection for events outside of the control of DNOs, particularly as during DPCR5 there will be increased activity on the networks leading to a greater risk of loss of supply during construction outages.

D6: Guaranteed standards of performance

Question 1 Do you agree with the proposal to increase guaranteed standard payment levels to reflect inflation?

We feel that the increasing of guaranteed standards payments in line with inflation sends the wrong message to customers. These are not compensation payments for loss, the value of which may well increase with inflation, but rather a recognition of the inconvenience suffered by the customer. Given that inflation is currently at very low values there does not appear to be a need to increase these payments in order for them to be an effective driver for the service provided by DNOs and a recognition of the inconvenience to the customer.

Question 2 Do you agree with the proposal to introduce some form of payment cap for large one-off events?

Question 3 If you agree to the introduction of some form of payment cap, what is your preferred method?

Central Networks welcomes the proposal to introduce some form of payment cap for large one-off events. We would advocate a method similar to that used in the event of severe weather. This would involve an extension to the timeframe before customers are entitled to a payment, with a similar cap of £200 per customer. The criteria for events in which this standard would apply should be decided using a threshold based on agreed incident criteria. An example currently encountered, would be malicious or wilful damage to a substation causing major disruption, for instance. Application for exemption, could again be similar to that in place for severe weather exemptions.

Question 4 *Do you agree that rota disconnection interruptions should be treated independently of the multiple interruption standard?*

We believe that rota disconnections should be excluded from the guaranteed standards because:

- these disconnections are undertaken infrequently
- they are likely to occur as response to conditions beyond a DNO's control, and
- they are ultimately for the benefit of customers as a whole

This exclusion should not only apply to the multiple interruptions guaranteed standard; it should also apply to the IIS incentive scheme, with the impact being wholly excluded in a similar manner to the NGT low frequency event in 2008.

D7: Customer Service Reward Scheme

Question 1 *Do you agree with our proposals for embedding DPCR4 best practice?*

Central Networks has always adopted best practice highlighted by other DNOs where this has been possible to do so. The requirement for DNOs to adopt a proportion of the best practice initiative should not be problematic if this is applied sensibly. What is not clearly defined is how this proportion shall be established, given that not all initiatives are equal in size, scope, cost or transferability between DNOs. It is important that DNOs should only do what is right for their customers. There is a risk that if a DNO does not consider a best practice initiative as delivering value to their customers, or believe that their customers' interests would be better served by the implementation of other initiatives, then being forced to adopt the initiative would be the equivalent of having to pay a hefty "entrance fee" to compete. This may mean that DNOs have to discontinue schemes that are better for their consumer group to fund the best practice initiatives, or more likely, given the limited potential upside of the reward, DNOs may choose to opt out altogether. We believe that DNO's should retain a degree of independence to implement initiatives that are of real and lasting benefit for their customer base, assuming that they can adequately justify and provide evidence for the benefits of their actions. We believe that it is important that where DNOs claim to have implemented initiatives this is verified independently.

Question 2 *Do you agree that the scheme should be rationalised once the Broad Measure goes live in April 2012? If so, in which areas?*

We do not agree that it is appropriate to define narrow categories within the Customer Service Reward focusing on vulnerable and worst served customers. While there may be some overlap between the current definitions and the new categories within the broader customer satisfaction measure, there are still aspects of corporate social responsibility and wider communication which will not be covered by this. We feel it is better to maintain a balance between narrowly focused areas encouraging improvements for niche groups and including categories with broader definitions that recognize projects that benefit the entire customer base.

E: Networks

E1: Network Output Measures

Question 1: Is our proposed common methodology for network output measures related to general reinforcement and asset replacement expenditure appropriate?

We continue to support the aspiration to demonstrate the benefits from network investment through output measures. In general the proposed approach for general reinforcement and asset replacement where the output delivered is based upon the difference between a forecast position with and without investment appears workable. We are pleased that Ofgem recognises that the outputs cannot be hard targets with a mechanistic revenue impact and that DNOs need flexibility to adjust to changing circumstances.

We do, however, have significant concerns about the speed with which the framework has been developed and expectations that the links between outputs and investment levels will be adequately robust to use as a basis for financial penalties.

In populating the proposed output indices, DNOs have made a number of assumptions that have the potential to be flawed. Companies should not be adversely penalised for making best efforts to generate forecasts on load growth and asset degradation particularly where methodologies are new.

Question 2: Is our proposed process for determining whether a DNO has performed satisfactorily against its agreed DPCR5 outputs appropriate?

Business drivers, available data and asset management methodologies will change and develop and all have the potential to impact the delivery of initially defined outputs. The mechanisms being proposed to track such changes, whilst burdensome, will enable DNOs to explain variances.

It should therefore be possible to demonstrate the benefits that have been delivered.

Question 3: What approach should be taken if we determine that a DNO has failed to deliver against its agreed DPCR5 outputs? Have we considered all reasonable options to impose financial consequences for under-performance?

As we have stressed on numerous occasions the outputs process is new, has been developed rapidly and is unproven.

Linking delivery assessment to financial consequences using this immature mechanism introduces significant risk for DNOs.

We therefore believe that performance against outputs should be used to inform the robustness of DPCR6 investment proposals, rather than imposing any financial consequences.

Question 4: Should we apply different treatment to DNOs that fail to deliver the agreed DPCR5 outputs, depending on their level of investment relative to forecast?

DNOs should be in a position to explain why delivery of outputs has not been achieved. Where this is not possible it would be reasonable to expect greater scrutiny of future plans.

E2: Innovation Funding Incentive (IFI)

Question 1 *Do you agree with our proposal to retain IFI?*

Question 2 *Do you agree with our proposal to focus IFI on technical R&D, whilst creating the new low carbon network fund for the trialling of low carbon initiatives on the networks?*

The IFI has worked well during DPCR4 and has successfully encouraged DNOs to carry out R&D. The minor modifications proposed for DPCR5 are appropriate and this incentive scheme should be retained

E3: Equalising incentives and the information quality incentive

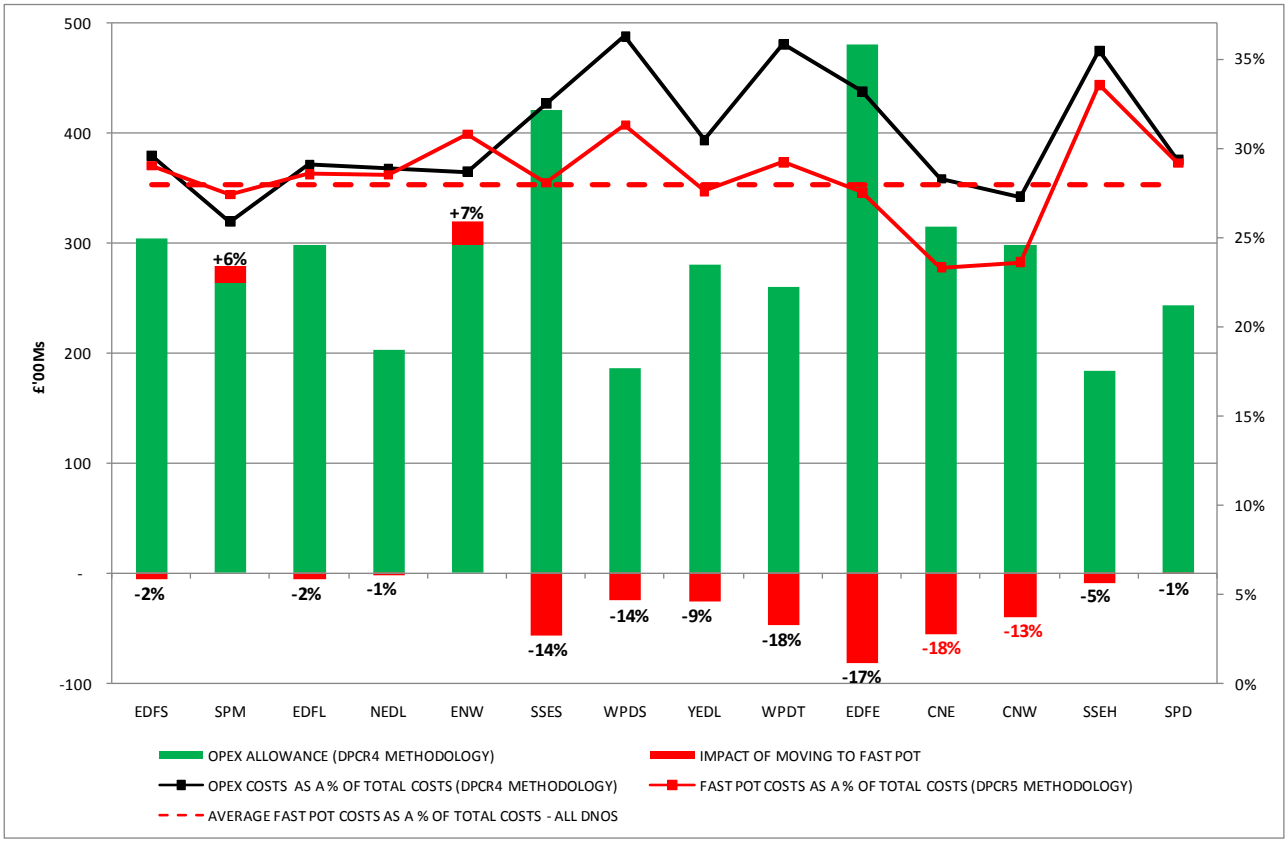
Question 1 *Does the 85 per cent capitalisation of all costs within the equalised incentive provide an appropriate speed of money?*

Fast/slow pot mechanism

Ofgem's move towards equalising incentives has led to a significant reduction in Fast pot allowance under the DPCR5 approach for both Central Networks East and Central Networks West, compared to Opex allowance under DPCR4 methodology and compared to the average Fast pot allowance as a percentage of total costs across all DNOs. Excluding pensions costs, this loss equates to approximately £95m of revenue over the DPCR5 period (£55m Central Networks East; £45m Central Networks West, 07/08 prices). This loss of revenue creates a significant problem for our business as it considerably reduces EBIT, Return On Capital Employed (ROCE) and Free Cash Flow (FCF) during the DPCR5 period compared to allowances under DPCR4 methodology. EBIT, ROCE and FCF are all key factors considered by our parent company, and other investors, when assessing performance of investment. These reductions would have a significant impact on how attractive our business is and this level of difference could be enough to put the funding support that we have secured at risk.

We do welcome Ofgem's movement towards equalising incentives and believe that the Fast pot/Slow pot approach is, in principle, appropriate. We wholly agree with the stated intention expressed by Ofgem to maintain the proportion of costs capitalised between DPCR4 and DPCR5 methodologies. Ofgem's original analysis suggested that around 80 per cent of network-related costs would be funded as "slow" money over 20 years through the Regulated Asset Value (RAV). This figure was later revised to 85 per cent. However, although applying this 85% capitalisation of network-related costs uniformly to all DNOs would result in only a small total movement across all DNOs, some DNOs would actually have increased Fast pot allowances compared to Opex allowances under DPCR4 methodology, whilst Central Networks East and Central Networks West suffer from large reductions in Fast pot allowance. The table below shows the impact on each DNO of moving to the new methodology:

Impact on allowances of moving from Opex/Capex to Fast/Slow pot methodology and allowances as a percentage of total costs (numbers stated on a Post IQI basis, in 07/08 prices, excluding pensions costs):



Although Ofgem may view any movement between the Fast pot and Slow pot as value neutral, which indeed it may be in pure economic terms, moving returns later in time does increase the risk for investors significantly, especially given that the cost of capital for future price controls, and therefore the long term return, is unknown. Ofgem must appreciate that, when trying to attract funding, Central Networks is competing with other investments which may provide earlier returns. Furthermore, with little indication from Ofgem regarding the level the DPCR5 cost of capital will be set at, we would be reluctant to agree any increase in the proportion of cost treated as RAV additions from DPCR4 levels.

To address this issue, we consider that Ofgem should base the DPCR5 capitalisation levels on DPCR4 levels of Opex allowance as a percentage of total costs, and that this should be done on a DNO specific basis, rather than in total across all DNOs. This could be done by making a number of adjustments, including adjusting the proportion of network-related costs added to the Fast/Slow pots to ensure that the Fast pot allowance as a proportion of total costs is the same as the Opex allowance would have been under DPCR4 methodology. Under this approach, the result for Central Networks East and Central Networks West would be that approximately 80% of network-related costs are added to the Slow pot, with the remaining 20% being added to the Fast pot. This is in line with the capitalisation level suggested by Ofgem in its May document.

Question 2 *Does the IQI matrix presented provide an appropriate profile for the incentive strength? Should we be considering an alternative profile with a steeper incentive rate?*

The change in IQI mechanism from the DPCR4 approach increases risk exposure of DNOs substantially. Whilst it is true that the broadened scope of costs slightly compensates for the change in incentive rate, the impact of this improvement is negligible when compared to the change in additional income and allowed expenditure factors. Either the existing DPCR4 matrix should be retained, or a suitable allowance must be made in the cost of capital.

To illustrate this point, we have modelled the impact of a variation in Real Price Effects (RPEs) from that predicted by Ofgem, since the IQI-roller mechanism is the principle means of mitigating this risk. Even using a fairly conservative probability distribution – with Ofgem's estimate of RPEs at the lower quartile and ours at the upper quartile, the expected value of increase in risk exposure is just under £65m, equivalent to an increased cost of capital of 0.45%.

Question 3 *What approach should we adopt when setting the start to earn points of the IQI matrix?*

This should be set as per the DPCR4 matrix. Uncertainty about future outcomes has increased which, as has been recognised by Ofgem, makes it more likely that Ofgem's forecast underestimates costs. Therefore increasing the upfront penalty would be perverse and would introduce further regulatory risk. Alternatively, as outlined above, the impact of the change should be reflected in an increased cost of capital.

F: Proposed allowed revenues and financial issues

F1: Allowed Revenues

Question 1 *Have we taken an appropriate approach to setting allowed revenues?*

No. Based on our recent market testing exercises, we do not believe we can deliver the required work volumes and hence outputs for the prices Ofgem is proposing. Requiring us to do so will mean that we will be unable to meet our parents' expectations of return and finance our business. Whilst Ofgem is encouraging companies to consider the proposals "in the round", the nature of outputs means that we have to consider deliverability in terms of individual programmes and the absence of a meaningful "minded to" figure for the cost of capital makes any broader consideration impossible.

Our key concerns are highlighted throughout this response. However, in summary, they are:

Fast / slow money split

- The 15%/85% ratio in the proposals seriously risks jeopardising our ability to earn a return commensurate with our parent's requirements. Amending this figure is an NPV-neutral adjustment – Ofgem's original choice of 20%/80% would be more reflective of our existing capitalisation ratio.

Opex assessment:

- Ofgem's analysis has some significant technical errors, particularly in the I&M and faults regressions. Its use of bottom-up benchmarking does not allow an adequately robust view to be taken and means existing allowances are set placing too much weight on benchmarks that are known to have questionable statistical validity.

Capex assessment:

- Unit price benchmarking has adopted the lower of the benchmark and the DNO's own unit costs creating an allowance which even the most efficient DNO cannot achieve. For further details, please see our comments below.

RPEs

- CEPA's assumptions in developing its labour RPEs contain some serious logical flaws, most notably the assumption that specialist labour rates will at most rise in line with inflation. Ofgem should question whether CEPA still considers these assumptions to remain appropriate given developments and new information since CEPA carried out its original work. Our comments in response to question 2 below summarise these concerns and are based on a note by First Economics for the DNOs, as well as highlighting our market evidence for specialist labour constraints. CEPA's assumptions about long term wage growth trends are also unjustifiably conservative.

- DNO risk exposure to RPEs in association with the suggested changes to the IQI mechanism (see section E) under the proposals is roughly equivalent to an additional 0.5% on the cost of capital compared to DPCR4 .
- Ofgem's Opex RPE calculation appears to have potential errors which we need to resolve – see response to Q2 below.

Losses

- Although not an allowance, the materiality of exposure means that customers and companies are still exposed to excessive risk.
- Use of 'Dispute Final' (DF) settlement data is required in target setting.

Workforce renewal

- We welcome the acknowledgement by Ofgem of the additional training and recruitment costs expected throughout DPCR5 and beyond, although questions still remain about the transparency and of the benchmarking. Please see our specific comments below.

Pensions

- Apparent double counting of deficit percentage attributable to distribution.
- Ofgem has applied an "efficiency score" with no adequate explanation of the assumptions behind it.

Tax

- Inconsistent approach to modelling of capital allowances vs. DPCR4.

Cost of capital

- The allowed revenues in the proposals cannot really be fully representative without a firmer view of the likely cost of capital.

Costs of reporting

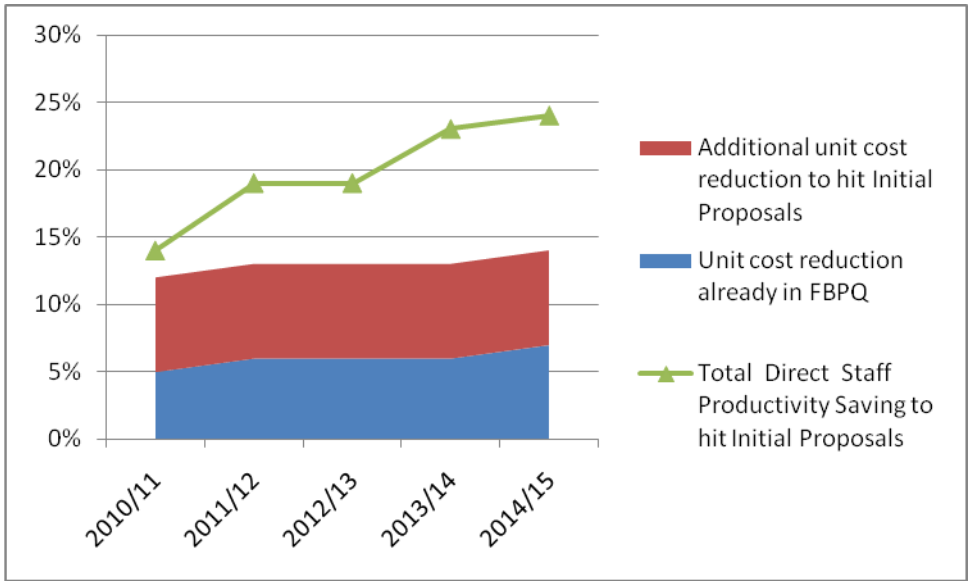
- In recent discussions with Ofgem, we have highlighted that DPCR5 will impose new reporting costs on DNOs. As requested, we will submit these figures in the near future.

Capex Unit Costs

To illustrate our view that the proposed unit costs benchmarking is overly aggressive and not compatible with delivery of our forecast outputs, the chart below shows the implied productivity savings that must be achieved to meet the plan by our new Alliance delivery structure. This portion of our work programme has been tendered for competitively in the last few months and therefore is a good picture of current market rates. As we set out below we found we had to be selective about how we divided up the work package due to market constraints for skilled electrical labour in order to reach our FBPQ budget forecasts, illustrating the high likelihood of significant labour RPEs in future. Additionally, our forecasts include assumptions for efficiency savings from systems and process improvements as well as "on-the-ground" labour productivity savings. It is these stretching assumptions that contribute to an extremely efficient plan which Ofgem acknowledges performs well under the IQI mechanism.

The Initial Proposals unit price assumptions imply a unit cost saving of 7% on top of this. Given the extremely challenging nature of the process and systems improvements already planned, this extra unit cost saving

would have to come directly from labour productivity. This would take total productivity savings to 24% or of the order of 2 hours per person per day, an improvement that could not be supported by the volumes predicted. This is in the context of a programme which has been robustly market tested (with nine tenderers) and optimised to deliver a stretching work programme.



Capex Volumes

In arriving at its proposals for allowed asset replacement volumes, Ofgem has compared 'implied lives' for each asset type based on each DNO's forecast replacement volumes. There are many, valid, reasons why asset lives could be different in different DNOs; the type of equipment purchased, installation practices, location, inspection and maintenance policies and the DNO's tolerance to risk. Many of these factors result from decisions taken long before the privatisation of the industry and cannot be realistically changed now. Although Ofgem has provided the opportunity for DNOs to present additional evidence in support of their replacement forecasts, because of the nature of the industry actual failure of most asset types is relatively rare and therefore absolute proof of asset life is extremely difficult to demonstrate. Central Networks' concern, supported by analysis done in developing output measures, is that the volumes of asset replacement included within Ofgem's Initial Proposals result in the overall condition of our asset base being worse at the end of DPCR5 than it is today. While it may be possible to mitigate the effects of this deterioration, increasing deterioration of the asset base is not a sustainable position in the long term.

Workforce renewal

We welcome the acknowledgement by Ofgem of the additional training and recruitment costs expected throughout DPCR5. At the time of writing, we are in dialogue with Ofgem to understand how the 'Baseline' element of the allowance is built into the overall revenue pot shown within the Ofgem revenue model. Ofgem has informed us that existing costs have been subject to benchmarking whereas the incremental costs have been included. Those companies currently investing will therefore lose out whereas those now looking to grow their resource will end up with all of their existing and future costs being allowed. We also question whether calculating the growth allowance based on capex unit cost reductions is a fair approach, when volume is the principal driver.

Question 2 *What assumptions do you think we should use for real price effects on DNOs over the 2010 to 2015 period?*

The assumptions we think Ofgem should use have been incorporated into our business plan. We have incorporated both productivity savings and real price effects.

Ofgem has understated the labour cost pressures facing DNOs over the next six years by refusing to recognise – either deliberately or through a misunderstanding of the nature of published cost indices - any sort of differential wage inflation for skilled infrastructure specialists.

In spite of the impact of the recession on employment numbers in manufacturing, construction and financial services some sectors of the economy, such as communications and healthcare, have maintained or increased employment and have continued wage increases for workers. Workers employed in the DNO sector have more in common with the latter. This is because the volume of work in the energy network sector (such as fault repairs and cable laying) is largely unaffected by the recession, capital investment levels will increase significantly through DPCR5 and there remains extensive competition for infrastructure specialist staff. Helm, Wardlaw and Caldecott [1]estimate at least £434 billion investment in UK infrastructure is needed by 2020. Although this offers some stability in volume of work, the scarcity of skills will apply an upward pressure on the wages of infrastructure specialist workers. Recent economic data supports this hypothesis, showing a premium to average earnings.

Table 1: Annual wage Inflation, Q2 2009 vs Q2 2008

Index	**Growth rate**
ONS: electricity, gas and water sector, incl. bonus	3.5%
BEAMA: electrical engineering	3.8%
BERR: civil engineering labour and supervision	5.5%
ONS: average earnings growth, incl. bonus	2.5%
ONS: retail prices index	(1.3%)

Note: the data in the table has been aligned to give a consistent picture at a specific point in time.

Before the end of the DPCR5 period it is likely that the economy will return to a steady state. At such times it might be expected that real wage growth might return to pre-recession levels. This is not the case in the Initial Proposals. CEPA appear to have incorrectly assumed that historic wage growth was driven by real wage growth. The trend actually appears to be driven by nominal wage growth. This suggests that the average annual wage growth for Ofgem to use should be 4.25%, and not 3.7%. Ofgem should then subtract its forecast of RPI to get to real wage growth.

As further evidence of the difference between general contractor and specialist costs, we again refer to our recent tendering exercise for our DPCR5 Alliance delivery model. Initially, we asked for tenders for an entire package of work encompassing general (e.g. cable laying, excavation and reinstatement) as well as specialist labour such as overhead line work. As a package, the direct costs we were offered came in on average up to 9% higher than our FBPQ forecasts for 2010. We then recut the work packages to insource overhead line

[1] Delivering a 21st Century Infrastructure for Britain
Dieter Helm, James Wardlaw and Ben Caldeco
Available at http://www.policyexchange.org.uk/images/publications/pdfs/PX_infrastructure_WEB.pdf

work, where this was possible, as costs we were offered by contractors were between two and three times higher than the cost of using our own staff. This enabled us to meet the FBPQ target, which includes substantial savings envisaged from reduced overheads from our Alliance partnership structure.

However, this experience continues to point to a shortage of skilled electrical infrastructure labour, even despite the recession, and we remain exposed to this.

RPE calculations (NOC and Indirect costs)

In addition to our views about Ofgem's assumptions on RPEs, we have noticed that our allowances for RPEs have been reduced by a substantially higher percentage than for other DNOs. We are concerned that this could be due to the calculation method applied by Ofgem and therefore would be keen to fully understand these calculations. We requested this information through the issues register we appended to our letter to Rachel Fletcher, Director of Electricity Distribution sent on 21st August.

In the absence of the detail from Ofgem, we have attempted to replicate Ofgem's RPE calculations by applying Ofgem's RPE rates [from page 82 of the allowed revenue cost assessment document] to Ofgem's view of our submissions. Our calculations result in RPEs some £7m higher than Ofgem's own calculations, using what we believe to be a consistent basis. We need to understand this discrepancy(see table below) particularly in respect of contractor assumptions which were omitted from the table on page 82 of the Initial Proposals..

Differences to Ofgem's RPE calculation £m	**CN East**	**CN West**	**Total**
RPEs for Network Operation Costs	1.5	1.4	2.9
RPEs for Indirect costs closely associated with direct costs	2	1.9	3.9
RPEs for business support	0	0	0
Total	**3.5**	**3.3**	**6.8**

The combined effect of Ofgem's failure to recognise the real price effects (RPEs) associated with salaries is a shortfall in allowances associated with NOC and Indirect costs of £25 million and a shortfall in capex allowances of £110 million. If not added to allowances this level of risk could be managed with a 50 basis point increase in the cost of capital.

Question 3 *What are your views on PwC's range for WACC?*

The wide range of the Weighted Average Cost of Capital (WACC) proposed by PWC in its report means that it is not a useful tool on which to draw conclusions for an appropriate cost of capital for DPCR5. The bottom of the range does not represent a viable cost of capital for a DNO and is at least 150 basis points below any recent UK regulated utility settlement. The upper end of the range is too low and does not allow for a cost of capital that reflects the current cost of financing, which is vital for DPCR5 given the unprecedented levels of investment needed by DNOs.

The report by Nera[1], prepared on behalf of the DNOs, presents an appropriate range of the cost of capital for DPCR5 of 5.2% to 6.0%, real vanilla WACC. We support this range and expect the final cost of capital for DPCR5 to be within this range.

Nera has also, on behalf of the DNOs, provided Ofgem with its feedback on PWC's range for the WACC. Central Networks supports Nera's response and we encourage Ofgem to consider this document carefully in its review of PWC's proposals and in reaching conclusions for the cost of capital in the final proposals.

It is important for transparency that Ofgem is clear about how the final proposed cost of capital is derived. The different elements of the WACC need to be consistent with each other and represent a thoroughly considered approach to establishing a fair cost of capital for DPCR5, given the additional investment required and the current cost of financing. The WACC is the cost of financing DNOs not a price control balancing figure.

In particular the following elements should be considered carefully for the WACC:

Risk free rate (RFR)

The use of 5 to 10 year averages for index linked gilts (ILGs) is not an appropriate stand alone measure of a long term risk free rate. The excess demand from pension funds following the introduction of FRS17 has depressed yields in ILGs, indicating that it is not useful in setting the lower end of the range for the RFR.

The initial proposals analyse the period from Jan 2000 as the basis for determining "long term" averages. An eight to nine year time period certainly does not match the lives of the core assets within the industry and the specific period chosen is not representative of much longer run historical data.

For an alternative view, which considers longer run data, we have calculated the real yield (on an annual basis) on UK 2.5% Consolidated Stock. This is the oldest gilt in issue and we believe that it represents a reasonable proxy for the very long term record on the risk free rate.

Depending on the backward looking time horizon chosen, the simple average yields can be calculated as follows:

[1]**Distribution Network Operators' Cost of Capital for DPCR5** A Report for the DNOs
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/NERA%20DPCR5%20WACC%20Report.pdf

Time Period	*Average Real Yield*
Last 10 years	1.92%
Last 20 years	3.00%
Last 30 years	2.88%
Last 40 years	2.09%
Last 50 years	2.29%

The 1.92% average for the last 10 years is consistent with Ofgem's quoted averages. This period does, however, produce the lowest average of any 10 year period going back to 1981. In the context of the very long term record it is impossible and inaccurate to conclude that the recent 10 year average is representative of the "norm".

The above example demonstrates how approaches to the calculation of the RFR can produce different outcomes. We encourage Ofgem to ensure that they consider broad and robust data when considering the different elements of the RFR.

Cost of debt

In determining the cost of debt for DPCR5 consideration should be given to the current cost of financing, as well as long term data. DNOs will need to raise debt during DPCR5 to enable them to both refinance some of their existing debt and to achieve the investment required on the network. It is important that the determination on the cost of capital provides sufficient allowance to enable DNOs to finance their activities.

Cost of equity

Meeting the requirements of equity investors is an important role of the cost of capital. With limited access to funds, there is strong competition for investment in energy and infrastructure companies. This applies to both external and group finance arrangements. The low end of the cost of equity range proposed by PWC would not meet the requirements of investors.

Observable evidence on current infrastructure equity returns comes from looking at recent activity of infrastructure funds (and like investors). This shows that prices and the success of transactions have been affected by investors' requirements to maintain or increase their target equity returns:

- Where funds have the resources to invest, target returns have increased as a consequence of the scarcity value of equity and resource allocation, with other asset classes offering higher returns on a risk-adjusted basis.
- The limited availability of debt has a significant impact on equity returns. The effect of a 20% reduction in available gearing on a typical investment in a RAV-based business would be to reduce equity returns by c.25% all other things being equal.
- Preservation or enhancement of equity returns at lower gearing levels points to a significant reduction in the price paid for assets; a 15% reduction in enterprise value (of the typical investment) preserves the equity return at the lower gearing levels

- Evidence from the Gatwick sale process demonstrates this in practice:

    1. Many bidders withdrawing or restructuring bids because of difficulties in arranging finance
    2. Stapled financing offered at 65% of RAV with 18 month tenor
    3. Rating agency indications of senior debt at a level of only 45% of RAV
    4. Final bid (rejected) at c. 83% of RAV in contrast to the vendor's original aspiration of a c. 5% premium to RAV

Gearing

We support the gearing range of 55% to 65%, and would encourage Ofgem to use the lower half of this range in determining the cost of capital for final proposals. Well capitalised companies benefit consumers by having the necessary flexibility to maintain investment and service levels during periods of uncertainty and enable DNOs to better withstand 'shocks'.

Financeability

DPCR5 is a period of significant investment for DNOs and it is important that the final proposals for DPCR5 are made on a basis that supports this. Our current experience of financial markets indicates that only a credit rating of A or A- allows good access to funds and investment at an efficient price, and should be deemed 'investment grade'. It is therefore important that Ofgem recognises this and incorporate it consistently into the final assumptions for the cost of capital and financeability testing.

Question 4 *Do you think we need a mechanism to address cost of debt uncertainty?*

See response to Question 5 below.

Question 5 *What are your views on the debt trigger mechanism?*

Our view on a debt trigger mechanism, consistent with our previous responses, is that this is not a practical solution to managing the uncertainty around the cost of debt. There is enough evidence on the current cost of debt that can be incorporated into a cost of capital for DPCR5, if recognition is given to the level of new debt and refinancing required by DNOs to make the significant investment in the network required. The report by Nera laid out a methodology for recognising this and we recommend that this is considered by Ofgem when determining the cost of debt for DPCR5.

F2: Pensions

The initial proposals (and modelled allowed revenues) stated that "we have maintained the methodology used to compute pension cost allowances at DPCR4". We were disappointed to see that there were variations to the DPCR4 treatment, in particular the introduction of an efficiency factor. The introduction of this is not consistent with the DPCR4 pensions treatment or the status quo presented in the recent pension consultation document. No further explanation has been provided to support the introduction of this or the methodology behind it. The efficiency factor should be removed for future revenue calculations prepared on a DPCR4 basis.

We are also concerned regarding a number of the calculations in the proposed revenue calculations for initial proposals, which have a significant effect on the revenues for Central Networks. We are working with Ofgem to correct these, in particular they relate to:

- Double counting of regulatory fraction
- Treatment of ERDCs
- Treatment of deficit repair periods

Individually and collectively these are high value items and it is important that they are corrected in Ofgem's revenue modelling as soon as possible.

We are working with Ofgem to ensure we understand fully its approach to the treatment of pensions and have responded separately to the Second Pensions Consultation document published on 31 July. We are pleased to see that the steps we have taken to efficiently manage our pension liabilities have been recognised and that there are significant structural and historical reasons why different pensions treatment in the energy sector is appropriate. We therefore support a continuation of the pass-through arrangements in DPCR5 and do not accept that this will necessitate an adjustment to the cost of capital.

F3: Tax

Question 1 Do you agree with our position on the tax methodology?

We agree with Ofgem's approach in setting ex-ante allowances for tax and believe that, subject to the tax trigger, DNOs should be incentivised to manage their tax liabilities efficiently and should bear the risks and rewards of doing so.

Calculation of capital allowance pools

During DPCR4, Ofgem used its own methodology to model movements in the capital allowance pools when calculating the tax allowance. This has resulted in Ofgem's modelled capital allowance pools becoming "out of synch" with DNOs' actual or forecast capital allowance pools. For DPCR5, Ofgem is proposing to use DNOs' actual (or forecast) capital allowance pool balances to calculate the tax allowance. However, the actual/forecast and the modelled capital allowance pool balances can be significantly different and, where the actual balances are higher, this will result in the customer benefiting twice from providing DNOs with lower tax allowances, as the difference between the pool balances will effectively be deducted twice from taxable profit before the tax allowance is calculated. This is a significant issue; for Central Networks this difference will result in a reduction to the tax allowance of approximately £9m over the DPCR5 period (£5m CNE, £4m CNW).

We can see no advantage to this change in methodology. Firstly, the opening capital allowance pool balances provided by the DNOs will only be a forecast at this point and are unlikely to be finalised for some years, until all the computations for the DPCR4 period are agreed with HMRC. Secondly, as Ofgem is also proposing using a "common" methodology for allocating expenditure to capital allowance pools, this will result in modelled pool balances immediately diverging from the actual/forecast position once again, resulting in the same problem at the end of the DPCR5 period. Thirdly, DNOs' actual/forecast pool balances are based on the DNOs' statutory capitalisation levels rather than Ofgem's interpretation of capital. It would be unfair to penalise DNOs for any such differences through higher capital allowances when Ofgem may not even have given allowances for such costs (e.g. capex overspends). Rather, we propose that Ofgem continues to use modelled pool balances from DPCR4. If Ofgem does use actual/forecast opening pools then it would be only correct to allow a one-off adjustment to the tax allowance for the impact during the DPCR5 period of the differences between these and the balances on modelled closing pools, and to commit to doing the same at the end of the DPCR5 period/beginning of DPCR6. It would also be more appropriate to use DNOs' actual approaches to allocating expenditure to pools during DPCR5 to avoid such large differences, and therefore problems, arising again in the future.

Unless Ofgem either uses the modelled pool balances or make a one-off adjustment, it will not achieve its stated objective of funding the tax burden of DNOs, as the tax charge funded will be lower than that paid by the tax on the difference between the modelled and actual/forecast pools – a difference the DNOs may never

be able to recover. It should also be noted that the majority of DNOs are already losing out under the tax allowance by having gearing levels lower than that assumed in its calculation.

Ofgem also states that it will not take account of the enhanced first year allowances for assets purchased in 2009-10. However the pool opening balances should be lower as a result. We have provided information to Ofgem on the impact of this and emphasise that this issue should be reflected if actual opening pool balances (with a one off adjustment for the difference between this and modelled pool balances) are used.

Question 2 *Do you agree with the proposal to establish a tax trigger mechanism and that we have established an appropriate balance between incentivising DNOs to manage their tax risks and sharing the risks and rewards with consumers?*

We are broadly supportive of Ofgem's proposal to establish a tax trigger mechanism However, the following issues should be considered:

- We consider that, in order to ensure events of an appropriate magnitude, such as the 2% change to the headline rate of corporation tax during DPCR4, are captured within the trigger, that a trigger level of 0.25% of price control revenue should be used.
- We are still concerned that Ofgem's definition of legislative changes is too narrow and does not include changes in case law, accounting standards and HMRC interpretations. Some of the most significant issues to impact tax charges recently have resulted from interpretation of case law, for example the introduction of Deferred Revenue Expenditure, which has never been legislated, and we believe it is essential that such changes are captured in the scope of the trigger mechanism. Furthermore, one of the most significant changes which may impact the tax charge during DPCR5 is the introduction of IFRIC 18, an accounting standard, which is discussed in more detail below.
- Further detail is required regarding the operation and timing of the tax trigger mechanism. We agree with Ofgem that DNOs' revenues should be adjusted for the trigger event in the subsequent regulatory year and calculated by re-running the DPCR5 financial model. However, the adjustment must reflect the full impact of the trigger event, including any impact in the year in which the event occurs. The adjustment must also continue for every remaining year of the price control, to ensure that the DNO is compensated for the full impact of any changes over the price control period. Furthermore, the impact of any changes in case law, accounting standards and HMRC interpretations should be "logged up" and it should be the cumulative impact of these, rather than each change alone, which is assessed by the trigger mechanism.
- When considering the impact of the trigger on the cost of capital, Ofgem must reflect that the working of the trigger is symmetrical and, by its introduction, DNOs are risking the loss of an opportunity to benefit from any reductions in tax charge compared to the tax allowance which will now be captured by the trigger.
- We believe that the adjustment made when the tax trigger is activated should only be for the excess over the trigger point.

IFRIC 18

In January 2009 the International Accounting Standards Board issued IFRIC 18 "Transfer of assets from customers". This may have a huge impact on accounting for assets transferred from customers which are used to connect the customer to the network as it appears to require that related income must be recognised immediately. This would in turn result in a higher tax charge.

IFRIC 18 is issued under the International Financial Reporting Standards (IFRS) and is proposed to apply to all transactions from 1 July 2009. Although Central Networks does not currently prepare accounts under IFRS, the UK Accounting Standards Board has signalled that in all likelihood by 2013 all companies will be required to convert. This would result in a significant increase in the tax charge for Central Networks when this conversion occurs or sooner if accounts are prepared under IFRS before this date. It is essential that any such

impact is captured by the tax trigger and therefore that the tax trigger includes the impact of changes in accounting standards.

F4: Excluded Services

Question 1 *Do you agree with our proposal to bring the distribution of units to new EHV premises, provision of charging statements and reactive energy transportation within the scope of the main charge restriction conditions?*

Ofgem is proposing to bring reactive power costs and revenues within the scope of the main price control. In the past, reactive power was treated as a relevant excluded service. This encouraged DNOs to charge customers with inefficient power factors, as DNOs benefited by a proportion of these charges, and by charging customers this encouraged them to invest in power factor correction. Bringing reactive power revenues and costs within the price control would remove the incentive for DNOs to identify and charge premises with inefficient power factors as they would not benefit financially from doing so. By not charging customers with inefficient power factors, customers would not be incentivised to invest in correction. This will therefore result in ongoing system losses which could otherwise be reduced. We therefore recommend that Ofgem continues with the DPCR4 treatment of reactive power as an excluded service.

Regarding the provision of charging statements, we agree that the costs and revenues of this activity are relatively immaterial and that it could be brought within the scope of the price control.

Question 2 *Do you agree that revenue protection services should be exempt from a RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party?*

We agree with Ofgem's proposal that, where reported revenues exceed forecast revenues for revenue protection there should be no deduction. However, we believe that this should apply to all work, not just that commissioned by third parties.

Question 3 *Do you agree with the proposed RAV adjustments for top up & standby, other system charges and metering excluded services where reported revenues (costs in the case of metering) exceed forecasts?*

We believe that the definition of other system charges should not be broadened to include revenues from non-network activity. Items which Ofgem is proposing to bring into this category currently meet the licence definition of de minimis activity, which is any activity carried on by the licensee other than Distribution business. Distribution business is defined as the distribution of electricity through the distribution system. Items such as mast income are not a function relating to the distribution of electricity through the distribution system and so by definition must be de minimis.

If Ofgem wishes to change the definition of other system charges to include such items as a relevant excluded service, DNOs should be compensated for any loss of revenue as a result of this change of definition. Alternatively, Ofgem could change the treatment of other system charges so it is treated as a "non-relevant" excluded service.

In relation to top up and standby, we propose that these items are treated as a "non-relevant" excluded service in order to stimulate the development of distributed generation. Top up and standby charges relate to services provided to customers with on-site generation capacity. Encouraging DNOs to provide such

services, by allowing them to retain the benefit of doing so, could facilitate the growth of distributed generation.

Question 4 *Do you agree with our proposals with regard to diversion works in DPCR5?*

We support Ofgem's proposals to retain the same treatment as for DPCR4 for diversions.

Question 5 *Do you agree with our proposals regarding metering excluded services?*

We consider that the treatment of metering excluded services should remain the same as in DPCR4, which is to be treated as a "non-relevant" excluded service.

Treatment of excluded services costs in Ofgem's financial model

We are concerned that the treatment of excluded services in Ofgem's financial model does not reflect the proposed treatment in the Initial Proposals document and is resulting in double deductions of costs to the detriment of the DNOs. Where Ofgem is proposing to bring an excluded service within the price control, the indirect costs should also be included within the price control calculations, which is currently not the case in the financial model. Where Ofgem is proposing to treat items as "relevant" excluded services, it is incorrect to deduct revenues from allowances which do not include the corresponding costs. We have communicated this in more detail to Ofgem and expect the financial model to be updated to reflect this error.

Treatment of sole use connections – clarification required

We support Ofgem's proposal to transfer sole use connections outside the Price Control and agree that they should be treated as a "non-relevant" excluded service. However, further definition is required from Ofgem regarding exactly what will be transferred and how the application of the regulated margin will work. We discuss this in "Connections Incentives and Obligations" Section 10, Question 6.

G: Cost assessment

Question 1 *Have we taken an appropriate approach to assessing costs?*

Capital cost assessment

Central Networks has been keen to support the degree of interaction between Ofgem and ourselves in the run up to the publication of both the May policy paper and these Initial Proposals. In contrast to operating cost benchmarking, the methodologies adopted by Ofgem for capital activities have been much more transparent than in previous Price Control Reviews and the opportunities to provide additional evidence in support of submissions have resulted in much more robust Initial Proposals. However, there remain a number of areas where we believe that Ofgem's conclusions are incorrect and should be revised for the Final Proposals.

Analysis carried out by Ofgem for the May policy document indicated that the Central Networks' costs for additional 132kV and EHV capacity for general reinforcement were low compared to the rest of the industry. However, subsequent unit cost analysis carried out for the Initial Proposals suggested that the opposite was the case and an interim reduction was made to allowances on this basis. This analysis had not been shared in advance of the Initial Proposals and we were able to demonstrate that the unit costs supplied were not representative of the scheme costs and that no reduction was justified in this area. Ofgem informally agreed with our conclusion and this should be reflected in the Final Proposals.

The analysis of asset replacement unit costs and its method of application have resulted in a systemic bias which has led to all DNOs experiencing reductions as a result of its submitted unit costs. In arriving at its benchmark unit costs, Ofgem has chosen to adopt a median value from the DNO submissions. However, because of the significant scope and definition differences that clearly exist within the DNOs' submissions, in the majority of cases an 'adjusted' median has been used to set the benchmark. This is not necessarily wrong, but, without the information Ofgem has obtained from all the DNOs and the rationale behind their decisions, it is not possible to judge the robustness of the analysis. However, irrespective of the method Ofgem has used to arrive at benchmark unit costs, it is the way that they have been applied which produces the systemic bias in the analysis. By allowing only the lower of the DNO's own costs or the benchmark, Ofgem has ensured that no DNO, however efficient, could realistically escape some reductions and this is apparent in Table 8 of the Cost Assessment Appendices. In Central Networks' case, almost two thirds of its unit costs are below Ofgem's benchmark; most are significantly so. This indicates that Central Networks' procurement processes are robust and that prices obtained for equipment and services are generally lower than the average for the industry. It is, therefore, irrational to suppose that where Central Networks' costs are higher than the benchmark it is as a result of selective inefficiency in procurement when definitional or scope discrepancies are much more likely. Central Networks believe, therefore, that the assessment of unit cost efficiency should be undertaken in the round against all of the modelled asset classes and only when a DNO is seen to have above benchmark costs overall should unit cost reductions be made.

Ofgem disallowed two Fault Level projects in the Initial Proposals for Central Networks West because they considered the expenditure to be uncertain. We have demonstrated that these schemes are based on firm evidence and the allowance for these schemes should be included within the Final Proposals.

Operating Cost Assessment

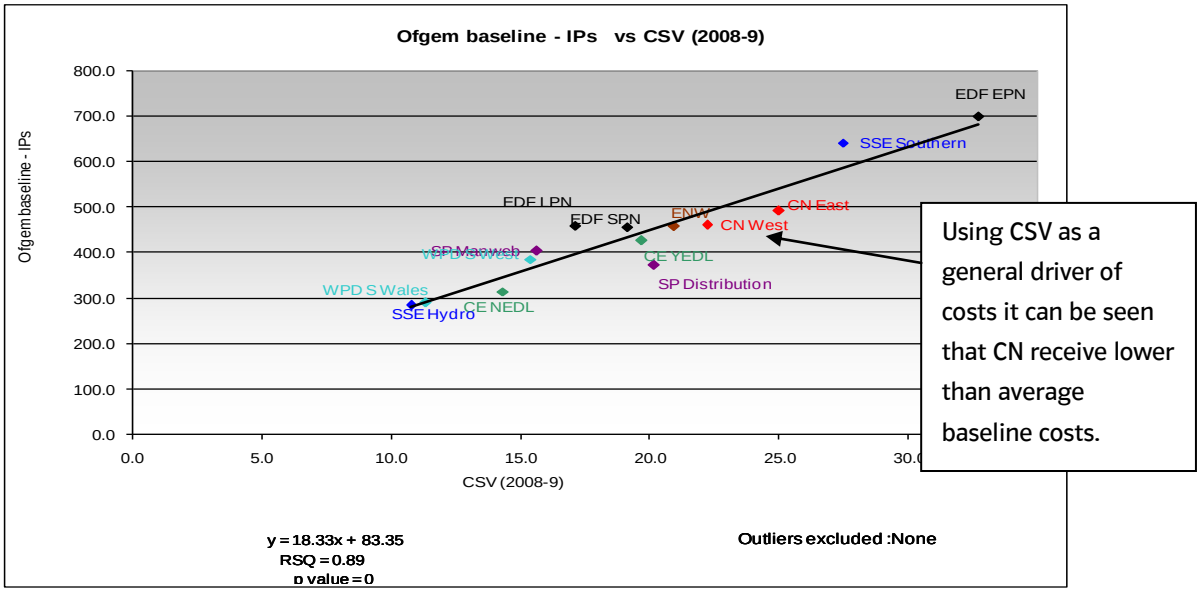
We believe that the method used to set operating cost allowances is affected by a number of serious flaws resulting in baseline costs that are below the level required to fund the industry at an efficient level. It appears that Ofgem's analysis underestimates the cost baselines across the industry by around 3% in comparison with the DPCR4 method. Given that:

- DPCR4 opex allowances have been overspent by the industry as a whole;
- there has been no evidence of frontier shift once Real Price Effects are excluded;
- costs will increase in DPCR5;

then we would not expect such a cut in allowances to result from recalculating efficient DNO costs.

The impact on Central Networks is around £20m per annum when compared a number of alternative approaches, including our preferred baseline setting methodology set out in Appendix 1. These views have been based on sound analysis of Ofgem's proposals and our own efforts to build up a more detailed view of factors affecting costs and thus construct an improved benchmarking methodology, considering both top-down and bottom-up regressions.

By comparing Ofgem's baselines to CSV, we can see that Central Networks is particularly adversely affected.



While top-down benchmarking methods are well established and robust, Ofgem has applied separate efficiency scores for network operating costs and indirect costs that reflect the less reliable bottom-up benchmarking.
This is problematic because:

- most of the bottom-up models used are affected by material technical errors such as the exclusion of costs or relevant values from the cost driver. This is especially concerning for the Faults regression (fault numbers missing) and the I&M regression (incorrect driver value for CNW);
- many of the models are poor at representing the drivers of cost as evidenced by the models failing statistical tests and having very low values for R squared. These poor quality models suggest an unrealistic spread of efficiency results that is not credible, especially where the difference is between DNOs in the same ownership group;
- deriving efficiency scores at this level is inherently less accurate than top-down benchmarking as the tradeoffs and reporting differences between individual network operating costs and indirect costs can

not be captured, nor can opex/capex tradeoffs be accounted for. Therefore we still favour top down benchmarking – the use of which would reduce the impact of inaccuracies with the bottom up analysis and improve the robustness of the conclusions;

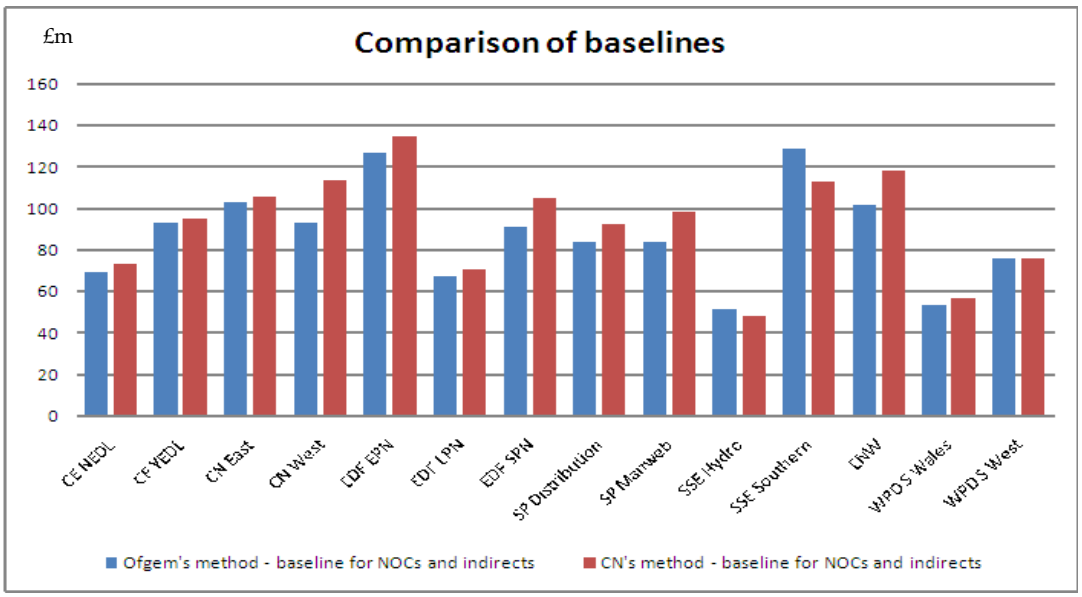
- additionally, for the reasons set out above, setting indirect allowances using the upper quartile level is not appropriate due to the cherry picking effect and degree of uncertainty around the quality of the regressions;

For bottom-up benchmark to add value to the cost assessment process we have to be certain that it is robust, does not contain fundamental errors and would stand up to external scrutiny. It is important that DNOs and other interested stakeholders can understand Ofgem's benchmarking approach, particularly so that Ofgem can demonstrate objectivity in the fulfilment of its duties. These issues undermine the validity of the benchmarking and its usefulness in driving cost reductions. **Therefore we believe Ofgem needs to revise its approach as outlined in this document, the key items being:**

1) Fix the technical errors identified relating to missing costs and drivers.
2) Incorporate the top-down benchmarking results (i.e. those already obtained by Ofgem) by one of the two proposed methods such that either
    a. An average of the six top-down models is used to determine the DNOs' efficiency and the upper quartile value (96%). Each DNOs average efficiency score is applied to both NOC and indirect costs with baselines set at upper quartile level.
    b. Average the NOC efficiency scores with the top-down efficiency scores before applying the hybrid baseline setting mechanism to NOC costs. Average the indirect cost efficiency scores and the top-down efficiency scores together before applying the hybrid baseline setting mechanism to indirect costs. (See Appendix 1 for more details.)
3) Replace the Overhead and Underground faults regressions with a single faults regression which also takes Non Quality of Supply (Non Q of S) costs into account.
4) Recalculate the Network Operating Cost (NOC) efficiency without using the tree cutting benchmark as this is unreliable and an inappropriate measure to set baseline costs for I&M and Faults activities.
5) Recalculate the Indirect cost efficiency score based on the single regression of all indirect costs.
6) Do not use the fixed effects model as this can introduce scale bias, but rather calculate the efficiency score using a pooled model without fixed effects and with the 2008-9 regression.
7) Reconsider the ongoing efficiency factor used to determine baseline costs as this is not representative of an industry where even the frontier DNOs are experiencing increasing costs.

The impact of these changes on the cost baselines is given in the chart below which shows the modelled cost baselines for 2008-9[2]. This compares the option b for item 2 above and suggests that the baseline allowances for Central Networks are around £20m lower using Ofgem's methodology. **The two most important priorities for us are correction of clear mistakes in Ofgem's benchmarking and explicit incorporation of top-down metrics into the allowance setting methodology**. This would not represent a major change since Ofgem has already derived these metrics. It would overcome some of the errors inherent in the bottom-up regressions and make Ofgem's approach more able to withstand robust external scrutiny.

[2] We have used the 2008-9 costs from the benchmarking tables to see the impact of different methodologies. Cost baselines are not replicated exactly as per table 4.1 in the initial proposals.



We are concerned that many fundamental issues are not resolved at this stage in the process. However, we have been making many of these points consistently to Ofgem since the May methodology paper, and have only been able to finalise our views with publication of the initial proposals. The reasoning and detail of our proposed amendments is discussed in the following pages along with a more detailed critique given in Appendix 2 which considers each regression in turn and Appendix 3, which considers the technical issues affecting the benchmarking as a whole.

Question 2 *What mechanism should be used to fund high value projects?*

There are two high value projects included within the Central Networks East submission. Two thirds of the expenditure on those projects is planned to take place during the first three years of DPCR5 and, because of the nature of such large projects, significant progress on them has already taken place. The expenditure on these projects has, therefore, a high degree of certainty and should be funded fully within the Final Submission.

Question 3 *What assumptions do you think we should use for real price effects and ongoing efficiencies for DNOs over the 2010-15 period?*

We answer this question in section F, question 2, and the opex cost assessment section and associated appendices.

Question 4 *Do you agree with our proposed methods for handling uncertainty?*

The DPCR5 forecasts have been made against a background of uncertainty within the industry greater than that experienced since privatisation. In light of this, a number of mechanisms have been introduced to the DPCR5 proposals to deal with this uncertainty. In general, these mechanisms are symmetrical in their operation providing protection for both customers and the DNOs. However, the nature of the price control process is such that the DNOs are unlikely to obtain the full funding required by their business plans and, hence there is an inbuilt offset which places more risk on the DNO than the customer. Where the DNO can control or, at least, influence the risk then this is entirely justified. In other areas, where the uncertainty is entirely outside the DNOs' control, there is less justification. In either case the degree of risk on the DNO and the extent to which the DNO can mitigate this risk should be recognised, for example in the Cost of Capital.

For more specific comments, please see answer to section H, question 4.

Question 5 *Are our proposals for volume drivers on low-cost connections involving shared assets proportionate, i.e. is the mechanism necessary?*

All DNOs' forecasts of high volume connections were produced when there was a great deal of pessimism regarding the depth and duration of the recession within the UK and this was reflected in forecasts of volumes significantly lower than those experienced in the recent past. However, there are, even before the start of the DPCR5 period, indications that the worst of the recession may be over and that there is increasing confidence in both the housing and manufacturing sectors. The likelihood is, therefore, that the new connections volumes will recover to their previous levels more quickly than was originally feared. In order to avoid excessive risk falling on to the DNOs, the true up mechanism proposed should be available during DPCR5 either automatically triggered by set volume variations, or manually by the DNOs.

The robustness of Ofgem's connections unit cost benchmarking is also questionable. For small scale LV domestic connections, the data from only five companies is used to calculate the average. EDF, WPD and SSE Southern all have zero values; and Central Networks and ENW are then excluded as high unit cost outliers leaving less than half of the DNOs in the calculation. Considering eight data points and then excluding three of those points simply for being higher than the remaining five is not a statistically acceptable basis for excluding outliers. We are pleased that Ofgem has taken steps to work out why our unit costs appear so different, but we remain concerned that this calculated average will be used in some way to limit connections spend.

The wide variation in unit costs suggests that using a simple average calculation will not produce any meaningful answer because it is extremely unlikely that these unit costs accurately reflect the different costs of connections for the DNOs. Not only has the data been gathered hastily (making consistency between the DNOs unlikely), but only a single year's data has been used, both of which go a way towards explaining the large variation. It would be irresponsible of Ofgem to use such a poorly calculated and non representative number in calculating allowances.

Ofgem needs to consider why there is such a large variation in their calculated unit costs and base allowances not on an average of only five companies, but an investigation into the individual needs or each DNO.

Question 6 *What is an appropriate materiality threshold for the operation of our proposed load related expenditure reopener?*

For the Initial Proposals Ofgem has indicated that it has identified schemes that do not appear to be supported by load growth forecasts. In the case of Central Networks theses schemes represent volume cuts equivalent to approximately 10% of our general reinforcement forecast. It would be unjust if Central Networks were penalised, by having to fund these schemes via the IQI mechanism, in the event that our forecast proved more accurate than Ofgem's. For Central Networks the upper threshold should, therefore, be no more than 10%. There is also the possibility of significant variation in the DNO contribution to the cost of high-cost low-volume connections which will depend on the exact location of the connection requests. This is not necessarily a volume variation but a cost variation that is, to a very large extent, outside the control of the DNO. A mechanism is needed to recognise the significant scope variations that can exist and, by reference to the assumptions built into the allowance, contribute to the volume variation used to trigger the re-opener mechanism.

Question 7 *Does the GDPCR reopener for TMA costs provide a good template for our final DPCR5 proposals for these costs?*

Due to the uncertainty around costs involved and timing of adoption by councils of the TMA we feel that a reopener would be the best approach. As well as this Ofgem should also be aware that there could be other changes in legislation in this area that could also be a trigger for such a reopener. We ask that when these

changes start to take affect that there is upfront dialogue between Ofgem and DNOs on the type of data and format required so that we can ensure all data is captured accurately as it is incurred as opposed to having to estimate historical costs in hindsight.

H: Risks and rewards

Question 1 *Do you agree with our approach to calibrating the price control settlement?*

It is important that in proposing a price control settlement Ofgem are satisfied that the package is sufficient to enable DNOs to finance the activities and will not drive bad behaviours or provide inappropriate rewards for underperforming DNOs.

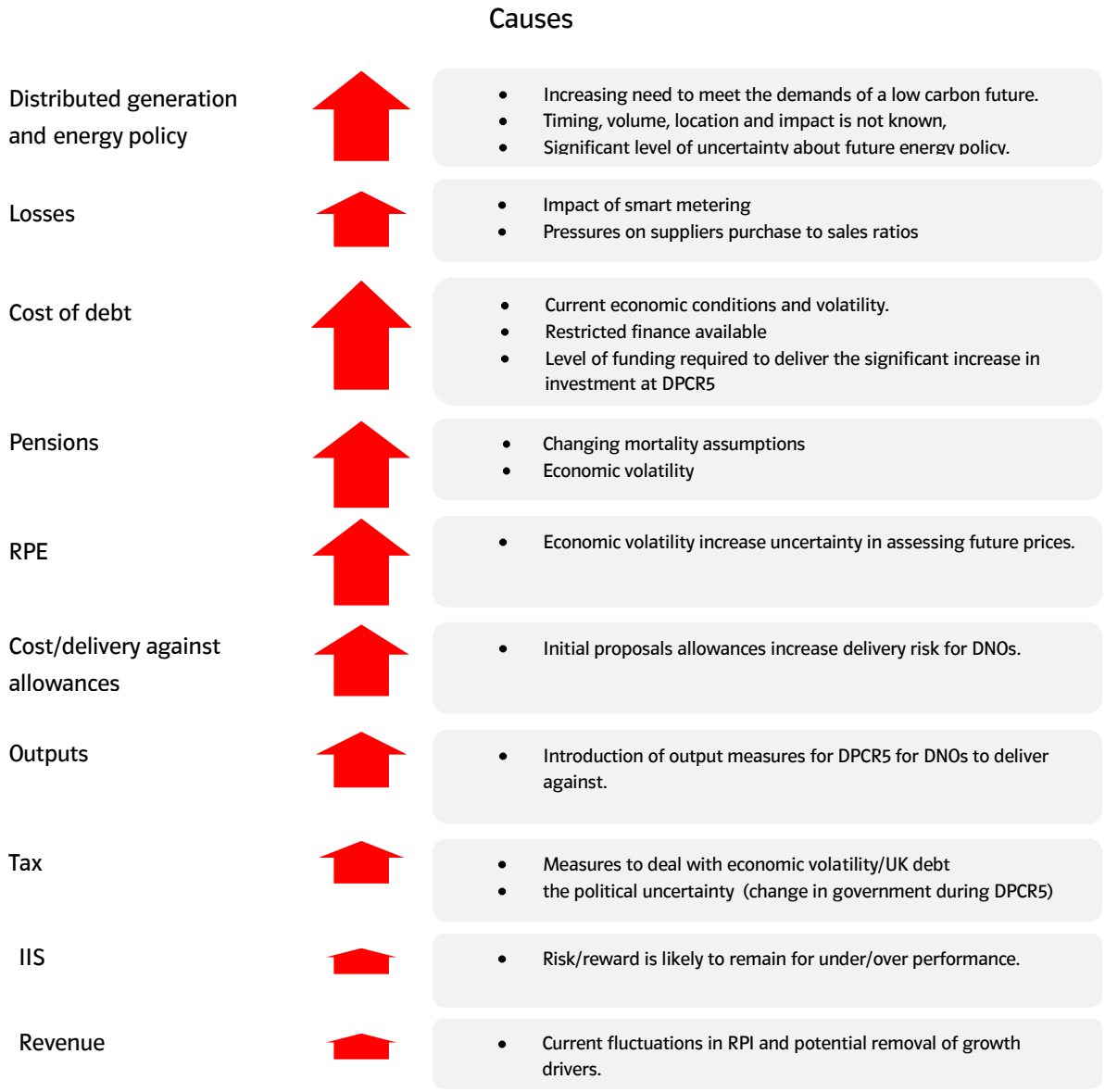
We do not support an approach that uses the cost of capital as compensation for other areas of the price control where insufficient funding is given to enable DNOs to meet their expected costs. The purpose of the cost of capital is to compensate DNOs for the cost of financing their activities, based on an appropriate and tested methodology based on market evidence. The rewards and penalties from incentive mechanisms should be separate from this and should be set such that the value range is consistent with the incentive. If overall, incentive mechanism are set to be symmetrical, then there is no adjustment necessary to the cost of capital.

In the Initial Proposals document the graph to show return on regulatory equity ('RORE') for DPCR4 was presented again. It would be beneficial if this graph were updated to show a more up to date position for the final two years of DPCR4, for which there is now one year of actual figures available (08/09) and a more recent and accurate forecast available for the final year (09/10). The final two years of DPCR4 are taking place in a different economic climate, with negative volume growth and high cost of debt, so it is important that the view presented on DNOs performance for DPCR4 reflects this.

Our business plan submission in February 2009 laid out our views on how risk should best be managed within the price control. Whilst we think that the cost of capital given as part of the price control settlement is important in recognising the levels of risk borne by DNOs, individual adjustments for selective factors is not appropriate and does not recognise the broader risks faced by DNOs.

Included below is an updated version of the diagram we presented in our business plan which gives an indication of the changing levels of risk DNOs are experiencing for DPCR5 compared to DPCR4. This list is not exhaustive, but highlights that the underlying levels of risk have increased in most areas of the settlement. We therefore think that the DPCR4 WACC of 5.55% (Vanilla, real) used in the revenues for initial proposals should be used as low case a risk adjusted cost of capital for DPCR5.

Scale of change in risk from DPCR4 to DPCR5



Question 2 *Do you think DNOs should be awarded a low baseline WACC and be given opportunities to earn more through outperformance, or a higher WACC with more limited opportunities to earn through outperformance?*

Ofgem poses a false dilemma in asking for views on the balance between incentives and cost of capital. An efficient company should be able to finance its activities and make a market-based rate of return, whilst achieving neutral performance on incentives. Where it can outperform expectations, and provide exceptional service to customers then this performance should be recognised in a higher rate of return, making it more attractive to investors. The inverse applies for companies with a below average performance. This approach mirrors competitive industries – those companies that perform well earn a return that is higher than average.

Therefore, we do not believe it is appropriate to use the cost of capital as a calibration tool for the performance of DNOs within the incentive mechanisms. We encourage Ofgem to ensure that its approach to setting a cost of capital for DPCR5 is true to its purpose, essentially an allowance for the cost of financing for the DNOs. This cost of financing is reflective of the overall risk faced by DNOs, and to assume some of this

cost should be made up via the incentive mechanisms it is an illogical and subjective move away from an established precedent

We do still encourage the use of incentive mechanisms by Ofgem, as they are a useful tool in encouraging correct behaviour. We also think it is appropriate to ensure that the reward and penalties to which DNOs are exposed through these incentives are of a scale appropriate to the mechanism. Finally, where the net reward/penalty across all DNOs is expected to be nil, then there is no need to adjust other returns further.

We encourage Ofgem to set a cost of capital that is appropriate for DNOs to finance their businesses (i.e. neither high nor low, rather what is fair) with no adjustments for outperformance as this is the most transparent approach for customers, investors and companies.

Question 3 *What comments do you have on our early views on how different incentives should be calibrated and the impact on customers' bills?*

Whilst we think this is an important debate, it is very hard to comment without having clarity on what assumptions Ofgem has made. We understand Ofgem has carried out some Monte Carlo modelling to look at expected outcomes of incentives. We would need to understand some of the assumptions behind this to comment on the range of RORE proposed. However, we believe the link between the losses incentive and environmental improvement is tenuous, because of the very poor short-term linkage between work done on the network to reduce losses and the output measure obtained from settlements. The level of exposure for customers and companies on the losses incentive given underlying volatility is also unrealistically high (equivalent to initial DPCR5 price increases) as we point out in Section C. As such, the implication that the losses incentive is reliably indicative of environmental improvement, and justifies a higher RORE exposure than quality of supply or customer service, is at best tenuous and at worse misleading. Therefore, in the absence of any other more suitable environmental metric, we would suggest that Ofgem could consider increasing the strength of the new customer service incentive as a counterweight to reducing losses exposure.

Question 4 *Do you agree with our proposed mechanisms for handling uncertainty?*

Whilst we do not agree with the detail of how some of the mechanisms have been implemented, Ofgem has correctly identified the areas that need attention. We are pleased that the potential impact of a change in energy policy has been recognised, and that reopener conditions have been tightly specified.

Similarly, we do have specific concerns about the two mechanisms for load related expenditure, although we agree with Ofgem that both are needed.

For the **low-cost, high-volume mechanism**, we agree with Ofgem's suggestion that "the unit costs might vary by DNO and also by the type of connection" (paragraph 6.7, Cost Assessment document). Discussions with other DNOs have revealed that there are no common patterns between companies in terms of policies that drive the scope of work in particular job (e.g. whether or not mains reinforcement is undertaken). Different companies have also made different assumptions when splitting the costs as required for their FBPQ submissions, due to a late change requested by Ofgem. Consequently, we expect a high level of risk that a single unit cost figure will be entirely unrepresentative.

Also, increases in volumes will indicate economic recovery which will drive up labour prices. As we have set out elsewhere, there is real evidence of a constraint on specialist labour which will drive real price effects beyond those assumed by Ofgem. These risks will be compounded by Ofgem's decision to log up additional connections costs. Whilst we accept that logging up is a useful tool for some costs and smoothes prices, the aggregate effect of the several logging up mechanisms proposed poses a significant cash flow risk.

In the case of the **high-cost low-volume** reopener, we are a little confused by Ofgem's approach. These projects have a separate mechanism because Ofgem acknowledges that the low volume and high variability in units costs makes benchmarking impossible. Yet, the implication seems to be that only a 20% increase in

volume would be considered. We question how this can be easily demonstrated given there is no such thing as a "normal" unit cost for this type of project, hence disaggregating price and volume variance will be difficult. This needs to be recognised by the final proposals as it will mean that determining "efficient" costs will not be possible using a mechanistic approach. Our interpretation of how this should work would be that the expenditure threshold acts as a trigger for a review (possibly by consultants) of evidence of increases in demand above the level forecast by the price control. Our output measures should form an element of this test, but given their immaturity and the fact they have not been tested, we would not consider outputs on their own to be robust enough to be applied mechanistically. For the reopener to be symmetrical, it is important that Ofgem is able to demonstrate that the standard of proof also remains symmetrical. Otherwise, the default assumption can only be that this mechanism would increase regulatory risk.

We cannot comment on whether the 20% is an appropriate threshold without better knowledge of the other key parts of the package that have yet to be resolved, in particular the cost of capital.

Overall, because of the thresholds and aggressive approach Ofgem has taken in assessing unit costs and RPEs, the proposals significantly increase risk for DNOs over and above DPCR4 levels rather than reducing it, as Ofgem has implied.

Ofgem asserts that the IQI sharing factor will provide some risk coverage for RPEs. Whilst this is technically true, the amount of coverage it provides compared to DPCR4 has been substantially reduced. Given Ofgem's initial position on RPE allowances, exposure to RPEs will be a significant risk that will need recognition in the cost of capital. As outlined in Section E3 the changes to the IQI mechanism increase risk exposure, not reduce it. This effect is dominated by the changes to allowed expenditure and additional income, which overwhelm the impact of a broader scope, which is itself partially offset by higher incentive rates. This change alone is equivalent to around 0.5% on the cost of capital.

Our views on the debt trigger and tax reopener are covered elsewhere in our response.