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Dear Rachel

EDF Energy response to the DPCR5 Initial Proposals

We are pleased to submit our response to Ofgem's Initial Proposals consultation. Our response to Ofgem's Pensions Paper, which is a key part of the DPCR5 picture, has already been submitted.

I would again like to thank you and your team, for the opportunity to meet with you last Thursday to discuss the key points of our response. Inevitably, as we were focusing on areas of concern, this was going to be a difficult session for both sides. Nevertheless, I believe the session was useful in helping to identify where more work is needed, by both Ofgem and EDF Energy, in order that a mutually acceptable set of Final Proposals can be developed.

There is clearly much to do in a short space of time, but please be assured that we are ready to contribute in any way necessary.

In the meeting, you reiterated the statement made in the Initial Proposals that EDF Energy were high cost, both for operational activities and for network investment.

With regard to investment unit costs, we noted in our presentation that there were comparability issues (principally between the modelled and non-modelled groups) which, in the context of an asymmetric approach to selecting values for Ofgem's modelling, is leading to an inappropriate result. In response, Ofgem stated that we had submitted relatively little information in support of our cost levels compared with the other DNOs.

We do not accept that we have provided insufficient information within the DPCR5 process. However, we recognise that we could have provided our information in a more easily digestible format to help Ofgem. With that in mind, we are pleased to have had the opportunity afforded by Ofgem's question N5075, to more clearly express what is driving our cost levels. We are grateful that Nick Russ has agreed to a short meeting on 15 September 2009, to enable us to further explain the context of this work. One specific element of our further cost analysis which we feel will be particularly useful to share is the level of investment in major projects during DPCR5 which will not be completed (and hence neither the volume nor the Outputs will be delivered) until DPCR6. This has a significant impact on apparent unit costs in some areas. We hope that our response, taken with those of the other DNOs, will create greater comparability and lead to more robust results.

The table below summarises our current position for modelled CAPEX costs. As Ofgem will note, except where legitimate circumstances dictate otherwise, our unit costs are not substantially different from those used by Ofgem in the Initial Proposals (the Industry median), suggesting strongly that EDF Energy is not a high cost company in this regard.

EDF Energy "modelled" CAPEX (£m)

	Ofgem proposed reduction	EDFE explanation provided
EDFE LPN	63.9	46.2
EDFE SPN	34.4	20.4
EDFE EPN	38.2	26.2
EDFE Total	136.5	92.8

Of course, we would expect Ofgem to require justification for our level of non-modelled costs. However, this has already been provided in a number of ways;

- Ofgem has (and has complimented us on) our scheme papers for our major projects;
- PB Power has examined and endorsed the engineering content of our major LPN projects;
- Major projects which will incur significant costs during DPCR5 but which will not complete until DPCR6 (as explained above);
- Consequential costs associated with major projects - such as significant cabling costs associated with switchboard replacements, exceptional substation civil works, and even tunnelling costs - which if included as modelled costs would adversely distort the derivation of unit costs;
- We also submitted a detailed paper to Ofgem explaining the apparent key differences within our CAPEX unit costs on the 19th June, including our key points on regional costs and urbanity in our DPCR4 CAPEX;
- Also we have provided answers to Ofgem's specific questions; NI5015, NI5018, NI5025, NI5026, NI5027, NI5028, NI5029, NI5032, NI5040, NI5046, NI5047, NI5048, NI5056, NI5070 & NI5075.

Should Ofgem want us to re-present this information, then we would be happy to do so.

In the meeting, we noted the Ofgem did not appear to accept that market testing is a valid justification for our unit costs. We agree that it is theoretically possible for a DNO to over-specify the scope of its investment work, and that would be an inefficient outcome. The one example quoted at our meeting was that we procure 'low loss' transformers. While that is true, this represents only a small increase in unit costs which, we believe, is entirely justified in terms of the longer-term carbon emission benefits. In fact, the driver of higher unit-costs (where these appear) has virtually nothing to do with purely discretionary enhancements to the technical specifications of the assets we procure, and far more to do with:

- The fact that we operate generally highly utilised networks (requiring assets with generally higher electrical ratings – including underground cables); and;
- For our LPN network in particular, the very high load densities and intensely urban environment under which our assets operate (for example, leading to requirements such as double-busbar 11kV switchgear, indoor (or GIS) EHV switchgear and complex, ultra space-efficient, substation designs).

- Our holistic approach to network investment which we believe will provide for greater investment efficiency in the longer-term (for example, a high proportion of 11kV RMUs are installed with an RTU providing remote control and automation functionality, and an important element of future-proofing - and we are increasingly employing 132/11kV direct transformation which will give rise to a more efficient asset base in the longer term);

None of the above legitimate specification enhancements and cost drivers are differentiated in Ofgem's unit cost benchmarking.

However, Ofgem has largely supported the volume of work we propose under asset replacement and has noted our low (or very low) capacity added/load growth ratios embedded within our general reinforcement proposals. Moreover, we have provided explanations of some of the particular project scope issues we face, for example Bankside, St John's Wood, Lodge Road, Brunswick Wharf – Finsbury Market (etc.) all of which are characterised by severe space constraints, proximity of adjacent infrastructure, outage constraints, the need for multiple-phase construction works and high costs of cable installation (including requirements for deep tunnels in some cases). In this context, we believe that competitively tendered market prices provide not only real evidence of cost levels but the only credible basis for judging whether the procurement and installation costs are efficient.

We also understand Ofgem's concerns about high value projects, and particularly the concern that DNOs should not be able to obtain an incentive benefit should such projects not go ahead or be delayed until subsequent price control periods. We have had useful discussions with Ofgem's team on how an open-book approach could work in practice. One of the advantages of such an approach would be that Ofgem would gain an understanding of the specific cost drivers we face on a scheme-by-scheme basis. This would overcome the difficult burden of proof we face in demonstrating why our costs are sometimes higher than other DNOs (whose detail project specifications we cannot see). An open-book approach would, therefore, remove a degree of risk to both EDF Energy and customers arising from the price control review process.

We have also presented information to Ofgem on indirect costs closely associated with network investment. In particular, for 2008/09, we have identified £7.3m of cost directly associated with seven very large and complex LPN schemes. Given the bespoke nature of these costs (they are the additional costs of dealing with complex, multi-phase projects), of the type not explained by Ofgem's benchmarking cost drivers it would be sensible to include these with the arrangements for funding high value projects.

In our presentation we raised a number of other key areas for us. In summary these are:

Alliance contracting

With regard to transparency of indirect cost reporting: as Ofgem is aware, we are delivering much increased levels of capex using an alliance contracting approach which provides complete transparency of indirect costs – in order for any cost comparison to be equitable, Ofgem must ensure that it has comparable information from the other DNOs before assessing whether our cost levels are efficient (we also noted the £5m of atypical start-up costs in 2008/09 should be removed from the benchmarking).

Losses incentive

As we have explained in detail to Ofgem losses for EPN have been at unfeasibly low levels during DPCR4 and are now returning to more credible levels (the degree of change being far more than possible due to engineering changes and therefore, we assume, are mainly due to supplier data management activity). This means that targets based on a five year average of past performance will be unachievable – and the associated incentive penalties will only act as a reduction to EPN's cost of capital. In this regard, we are please that Anna is proposing to have

working sessions with the DNOs which include target setting. As well as achievable targets, we are also requesting tighter caps and collars aligned with the maximum movement in losses attributable to DNO management action.

We currently spend around £5m per annum of data management activity, £2m of which has been included in the cost benchmarking (the balance is under excluded services). Had other DNOs responded so proactively to the incentive, these costs would be included in the benchmark. Currently, these costs were contributing to apparent inefficiency – which is clearly nonsensical.

We did not have time in our presentation to discuss the DPCR4 losses roller, so it is useful if we set out our position clearly here. Our legitimate expectation is that the losses roller should continue into DPCR5 except that no new settlements data, beyond the final 2009/10 RF, enter the calculations. Any departure from this would, we believe, represent a claw-back of incentive rewards which would significantly increase regulatory risk and the cost of capital.

Relative price effects

As we said in our presentation, we do not believe there is a case for capturing a frontier shift movement in revenue allowances for DPCR5. We noted Ofgem's comments in the meeting that we had made efficiency savings during DPCR4 and that this provide justification for future improvements. We would observe that if Ofgem believes we are less efficient, then our improvement in DPCR4 can only be seen as catch-up rather than evidence of frontier shift. In fact, our report on DCPR4 investment efficiency did not demonstrate significant opportunities for avoiding inflation or relative price increases. Instead, it demonstrated the very efficiencies that the proposed Outputs regime will capture going forward and which to a large extent, have already been built into our investment forecasts (hence the relatively low volume of asset replacement proposed and the relatively low level of additional capacity to be added). We believe that Ofgem should set incentives to encourage the DNOs to find improvements, rather than attempt to assert the improvements ex ante and allocate all of the benefits to consumers.

Irrespective of Ofgem's policy of frontier shift, we explained that it had made an error in removing £160m of RPEs from our network investment forecast since this represented a 2.1% per annum instead of the intended 1%.

Correction of modelling errors

We briefly discussed a number of errors we had identified in Ofgem's cost benchmarking and which we had already explained in detail to Ofgem's team.

Ofgem noted that what we might see as an "error" they may see as "modelling judgement". We are confident that the issues we raised will be seen by Ofgem as the former.

Connections performance standards

We explained that we cannot accept a new licence condition as we regard it as a disproportionate response to the problems that Ofgem has identified and in any case there is a high probability that we would breach the condition – at least in the post implementation period. We understand that Ofgem is concerned about the DNOs' current performance, and we accept the need for additional incentives for improving performance, including those which have a cost to us.

Discussions within Ofgem's connections standards working group have progressed well during 2009, however, there is still a lot of work needed to finalise the new performance standards for unmetered connections and the delivery of metered connections before implementation can begin. It will naturally take us some time to achieve the proposed standards given the implications for training, systems development and recruitment etc. It is, therefore, important that the final implementation timescales are balanced against the need to ensure DNOs and customers have sufficient time to understand and implement the new arrangements.

Structure of our response

We have structured our response so that it focussed mainly on the areas where movement is needed before an acceptable set of Final Proposals can be produced. We believe that such a focussed approach is more helpful at this stage and bearing in mind the time constraints on both parties, than us answering all of the questions raised in the documents. Our approach means that where we have been silent, we are supportive of Ofgem's Proposals.

Yours sincerely

Paul Delamare
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