

Electricity Distribution Price Control Review (DPCR5)

Initial Proposals

Electricity North West Response



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Executive Summary

The initial proposals as published indicate cuts in expenditure that would result in a significant, long-term reduction in service and an increase in service risk that would be opposed by our customers.

In the six weeks since the Initial Proposals were published we have continued to engage with the Ofgem team, honouring our commitment to support the ongoing development of its' comparative efficiency analysis, investment appraisal and financial modelling. We have received assurances from the Ofgem team that the completion of this work is likely to make a substantial change to our revenue allowances. This response will in part act as a summary of the key issues we have highlighted in our recent dialogue.

In developing, testing and refining our forecast business plan we took into account:

- the needs of our current and future customers in the North West;
- the needs of our efficient, yet inexorably ageing asset base; and,
- the views of a wide range of informed and engaged regional stakeholders.

This resulted in a series of outputs and objectives that our forecasts can efficiently deliver, whilst reflecting the impacts of undertaking our largest investment programme of the last half century, together with the unprecedented challenges of the move to a low carbon economy. It must be further recognised that we are planning on delivering these outputs and satisfying these objectives in the aftermath of a significant global economic crisis where there continues to be inherent volatility and uncertainty in the markets in which we operate. The initial proposals do not result in a revenue forecast that enables delivery of these outputs and objectives because of:

- unjustified reductions in the volumes of essential investment
- inappropriately disaggregated unit costs analysis
- under-developed comparative efficiency analysis that will not stand up to independent scrutiny
- material errors in the financial model
- unrealistic assumptions in the financeability tests
- penal incentive mechanisms

This response identifies practical solutions to all of these issues. Whilst many of these issues are already being addressed in our constructive, ongoing dialogue with the Ofgem team, the magnitude of change required is significant.

Potential impact on our customers

We do not accept that the initial proposals represent the most appropriate proposals for current and future customers in the North West. Unchanged, these proposals would:

- Increase the risks faced by customers in the North West of supply interruptions due to equipment failure and system overloading
- Increase the probability of an accident.
- Cause us to curtail long-term value adding activities such as research and development and ongoing development of our industry-leading CBRM tools.
- Result in an increased indirect expenditure requirement in DPCR6.
- Create an unsustainable and undeliverable step change in investment requirements for DPCR6 and DPCR7.

Without a substantial increase in cost allowances, our only option to fund essential, efficient activities would be to restrict investment and maintenance expenditure in other areas in order to manage our resources within the budgets you propose. We forecast that this would increase the risk of power disruption across the DPCR5 period, with a noticeable deterioration in the DPCR6 period and poor performance in DPCR7. In these circumstances, we would be unable to remain committed to the target outputs we submitted with our expenditure forecasts.

Given that Ofgem's own survey shows the importance customers attach to maintaining quality of supply and the high value they attribute to deteriorations, we do not believe that these proposals are in customers' interests. Perhaps more importantly, these restrictions would substantially increase the risk to customers of widespread and prolonged disruption to electricity supplies.

Potential impact on our business

Insufficient cost and revenue allowances have at least three potential impacts on our business and ultimately our customers:

- damage to our ability to continue to operate effectively within the required financial ratios;
- damage to the levels of service experienced by customers; and,
- damage to our ability to earn the necessary return that will ensure the continued re-investment and attraction of investors to the industry.

While in the short term, we may be able to manage within our existing financial ratios by cutting back on expenditure and not meeting equity return expectations, insufficient allowances will adversely affect the ability to attract debt and equity to the sector, which is competing in a global market.

The inadequacy of the cost allowances calculated for the initial proposals would not enable ENW to operate within the financial ratios unless we cut £168m from our asset replacement programme to fund other essential expenditure.

We understand that Ofgem intend to revise the cost allowances at the same time as completing the work on the financial model, issuing revised revenue forecasts on 5 October. We will comment further on the financial viability of DPCR5 when we have

received these revised forecasts, taking into account Ofgem's working assumptions for WACC and pensions.

The environment that DNOs now operate within is substantially more risky than at the time of setting DPCR4 as measured by volatility in capital markets, consumer price inflation, contractor rates and commodity prices. However, there is little recognition of the effects of this risk increase for DNOs in your proposals to date. In fact the tightening of targets in the Losses and Quality of Supply incentive schemes and the introduction of new incentives related to transmission exit charges and customer satisfaction further increase risk. The final resolution of the cost of capital debate will need to address all these factors.

We do not believe Ofgem's financeability test reflects investor and rating agency expectations in the current financial climate. We urge Ofgem to discuss this issue with the financial community so that the price control is conducted taking into account the important relationship the DNOs have with the financial markets. The financial model needs to be comprehensively stress tested for changes in key assumptions, e.g. RPI and interest rates.

Potential impact on environmental issues

The introduction and continuation of the environmental incentive measures is important to allow DNOs to facilitate moves towards a low carbon economy. Whilst we agree with the appropriateness of the desired behaviours, we believe that some of the detail of the proposed mechanisms may deliver unintended results. We have provided Ofgem's team with considerable evidence that strengthening the losses incentive scheme, in the face of unanimous opposition from all DNOs, will increase risk. We maintain the view that a lower strength output scheme for tackling theft and data accuracy accompanied with a stronger input scheme including the shadow cost of carbon, would be the best overall approach to managing network losses. We are concerned that the losses incentive mechanism as proposed will continue to divert attention to mitigating data volatility and the associated risks/penalties, rather than tackling technical losses which reduce carbon emissions.

We have been consistently supportive of Ofgem's ideas in relation to the development of a Low Carbon Networks Fund. However, the implications of the cost allowances calculated for the initial proposals, were they to remain unchanged, are that we would not be able to risk the expenditure associated with the identification, assessment and development of bids to the fund – rendering this initiative completely ineffective.

Potential impact on ongoing behaviour

We observe a worrying trend in the development of the incentive mechanisms within the Initial Proposals. It appears that the incentives will be set so that DNOs are likely to face significant penalties. Incentives must be set up with an expectation of neither gain nor loss in the design of the scheme, the setting of targets and in Ofgem's modelling of financeability. This ensures that the calculation of the cost of capital can reflect the financial evidence of the costs of debt and equity and does not need to be raised to address adjustments to regulatory risk. Penal incentive mechanisms do not work as intended because they have a tendency to drive unintended behaviour that seeks to compensate for the perceived bias in the mechanism.

Ofgem, DNOs and other stakeholders have expended considerable effort across successive price control reviews to develop a package of incentives that encourage appropriate DNO behaviours. Some of these measures are needed to fine tune the RPI-X incentive mechanism and others are needed to reflect the failure of the market to price externalities correctly. We must check back to ensure that the effects of ongoing developments in the incentive framework do not undermine these principles, especially when calibrating incentives using the RORE methodology. We advocate the development of a strong, unbiased incentive regime, focussed on driving the behaviours customers value without adding unnecessary regulatory risk.

Inadequate cost allowances

We are very disappointed that Ofgem's initial analysis indicated that you should disallow large sections of our robust business plan. In a number of areas the initial proposals disallow specific investments that we believe are so fundamentally important to meeting our legal and safety obligations that we would need to undertake the work even if there were no funding for it. In these cases, expenditure allowed for other important projects would need to be re-allocated to fund these essential unfunded activities.

We are broadly supportive of the development of disaggregated, comparative efficiency analysis and have invested considerable effort in assisting the Ofgem team to develop this approach through DPCR5. However, we do not believe this new form of analysis had reached a sufficiently robust level when the allowances for the initial proposals were calculated. Several key refinements are still required:

- Ensuring that the appropriate cost categories are included in the modelling
- Removing errors and omissions from the calculations
- Removing inappropriate cherry-picking that creates a benchmark based upon a hypothetical entity that does not exist
- Using the analysis to address the fact that some of the apparent "inefficiencies" in our indirect costs are as a result of being the only singleton DNO
- Taking into account a range of other evidence

We are resolved to continue to work with Ofgem's teams to develop a more appropriate analysis that will deliver a more sensible and balanced expenditure and investment plans that recognises both the need to control costs in the short-term and to ensure the network is maintained in a sustainable state.