

Electricity Distribution Price Control Review (DPCR5): Initial Proposals

Incentives and Obligations Paper

Electricity North West Limited Response

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Executive Summary

We observe a worrying asymmetry in the development of the incentive mechanisms within the Initial Proposals. 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. However, it appears that many of the DPCR5 incentives will be set so that DNOs are likely to face significant penalties. 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.

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. Furthermore, when combined with the very low expenditure allowances calculated for the initial proposals, the mechanisms are less likely to be effective, as all management would be diverted to cutting cost, rather investing for the future.

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.

We have provided the Ofgem 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. However, if an output scheme is to continue, we believe that the DG excess loss adjustment must continue to form an essential part of the package, if there is not to be a complete undermining of the DG incentive in a large portion of our network.

We fundamentally disagree with Ofgem's interpretation of the losses rolling retention mechanism. Given the acknowledged volatility underlying the losses incentive, it is totally inappropriate that the combined effect of the incentive and the roller should be driven solely by the snapshot of reported performance in 2009/10. It effectively renders the performance in the first four years of DPCR4 irrelevant, and actually magnifies the level of risk already inherent in the output scheme, for both DNOs and customers.

Similarly, we maintain that it is unnecessary and inappropriate for an incentive to be applied to the DNOs in respect of Transmission Exit Charges. We do not believe that the proposed incentive arrangement will deliver the desired behaviours.

Examination of the IIS as outlined in the initial proposals indicates that the balance of risk is now very much on the downside. The IIS target setting inappropriately penalises DNOs for good performance in previous years increasing the risk of penalty payments. If the significant reductions in expenditure allowances in the initial proposals and the consequent impact upon asset replacement in DPCR5 are not addressed, we would be unable to accept the IIS targets outlined in the initial proposals. The target setting methodology is predicated on maintaining the current fault rate across all asset groups. The expenditure reductions proposed by Ofgem will result in a worsening in current fault performance and we would expect that this performance degradation be reflected into future targets.

In addition the current IIS framework restricts the available investment returns for investment based improvements in CIs owing to the time bounding of IIS rewards resulting from your approach to locking in performance improvements. The narrowing of the band about the target as a result of an increase in the incentive together with the proposal to roll-forward performance year on year have resulted in a scheme which represents significant downside risk to our business. This can be addressed by a gradual locking in with a glide path approach such that both shareholders and customers benefit for a period after an investment to improve performance.

Ofgem have identified a number of concerns with the DNOs' connections responsibilities. We welcome the shift in approach to the regulation and incentivisation of this area. We welcome Ofgem's acknowledgement that there are different levels of competition across DNO regions and Ofgem's intention to introduce incentives for DNOs to be proactive in facilitating competition. We have some concerns that the proposals Ofgem have made do not fully support this intent and do not sufficiently recognise DNOs such as ourselves that have been proactive in supporting key Ofgem strategic objectives prior to any such specific new incentives being introduced. This issue can be addressed by undertaking competition tests on leading DNOs for the final

two years of DPCR4 and allowing a margin if they are found to have passed the tests early.

In relation to changing customer service and satisfaction incentives we are also concerned about the balance of risk and reward. The cost allowances calculated for the initial proposals would reduce our confidence in being able to fund and implement any new ideas or innovations in customer service. We have a concern that Ofgem are developing several new obligations without allowing an appropriate level of funding (as a result of a backward looking allowance setting process). We would have welcomed the development of the customer service regime as part of a sensible package of proposals, but against the cost allowances in the initial proposals the exposure of 1% of revenue to risk in this area would increase the likelihood of financial difficulty, push up risk and ultimately cost to customers.

Whilst we remain concerned about the overall size of the scheme to improve service for the worst served customers and its ability to reach down to the very worst served, we are particularly concerned about the investment risks introduced as a result of the post investment efficiency and efficacy tests that have been proposed. It remains our view that these tests ought to be removed and replaced with a high level assessment of overall performance and confirmation of investment eligibility.

Risks and Rewards

This chapter has been added here in response to the proposals set out in the main Initial Proposals document. It has not been numbered in order to retain consistency between the subsequent chapter numbers of this response and the Ofgem Incentives and Obligations document.

In line with previous settlements, Ofgem has proposed an incentive framework to encourage and allow the DNOs to undertake activities which are not naturally encouraged under a pure RPI – X system of regulation. We have always supported the development of strong incentives in previous price controls and believe that customers benefit from the inclusion of appropriate mechanisms. We are disappointed with the proposed framework for DPCR5 as the overall incentive package appears to be significantly unbalanced. There are a number of instances where these overarching principles of correcting inappropriate behaviours which are encouraged by RPI – X or where the market does not efficiently reflect the true cost of an activity are ignored and the mechanisms appear to be set to achieve a different outcome. We believe that Ofgem should set targets for each incentive mechanism at levels that DNOs expect to achieve. If mechanisms are set up where a DNO cannot achieve the prescribed level, this will ultimately require additional financeability uplifts and potentially a higher cost of capital. The risk exposure alone from artificially high targets increases the required cost of equity.

We are also concerned with the number of unfunded obligations placed upon the DNOs for DPCR5. This situation has arisen due to a number of factors including a backward looking allowance setting process, an evolutionary development of the regulatory framework from DPCR4 and the need to align cost allowances with policy decisions e.g. substation electricity. We are particularly concerned that Ofgem are aggressively targeting indirect costs. Many of these obligations result in increased indirect costs. We suggest that it is indirect activities that are likely to generate the type of innovation which Ofgem are seeking and also represent important customer services.

At the present time, it is difficult to assess the balance between risk and reward for DPCR5 due to a number of key exclusions and refinements. Namely: -

- Ofgem has not proposed a cost of capital. The range from the Ofgem consultants is too wide to be of enable informative scenario modelling.
- Ofgem has not proposed any mechanism to manage the increased volatility since DPCR4 as evidenced by the attached report by Oxera.
- Ofgem has placed increased obligations upon DNOs without recognising the associated cost.
- The different treatment of costs since DPCR4 will shift the risk profile of the DNO (pensions, exit charges, opex capex equalisation).

Ofgem raise the possibility that it may award a cost of capital at the low end of an appropriate range whilst offering significant outperformance opportunities. This appears to be a difficult option to accept given the design of the traditional regulatory framework. The cost of capital is in place to allow investors to recover appropriate levels of return for earlier investments and incentive mechanisms are introduced to encourage behaviours which are not compatible with cost efficiency. To suggest that a shareholder should not be fully compensated for previous investments and that full remuneration of that investment would be dependent upon performance against an indirectly linked measure would increase the perception of regulatory risk. The rational investor will demand a higher return if the returns available are exposed to greater uncertainty rather than the lower returns which Ofgem suggest are appropriate.

We are concerned with the suggestion that a different cost of capital is being considered for each area. This may change the investor view of the risk profile of an individual DNO and may distort accessibility to markets. It is very difficult conceptually for customers in different regions to be exposed to a different cost of capital. We are also concerned that this may set a precedent for future reviews and therefore is an issue which would be more sensibly explored under the RPI-X @ 20 review.

Oxera has completed a report for ENW which assesses the scale of the volatility in DPCR5 compared against the same metrics in DPCR4. The report concludes that the events since the 2004 price control have created a rational basis for heightened perception of tail risk. Ofgem has suggested that “it has duties to ensure that licensees are able to finance their activities and they would therefore have to give serious consideration to reopening the price control”. Whilst this statement is helpful, it does not provide any certainty or formality for investors. The Ofwat substantial effects clause provides investors with a formal route to apply for a reopening of the price control, subject to specific conditions. We believe that these conditions are too wide to provide the level of protection that is required. We suggest that Ofgem apply a substantial effects clause into the price control, but without a percentage revenue test. This will allow Ofgem to formalise its duties, enables a case by case determination of whether the effects of a particular situation are substantial and provides DNOs with a route to appeal to the Competition Commission.

Given its prominence in the early stages of the DPCR5 negotiations, there is very little explanation of the RORE modelling. We are concerned that Ofgem provide very little detail on the sensitivity analysis conducted and how the relative incentive mechanisms have been balanced. Despite numerous assertions, there also appears to be an informal cap on the total returns package which is then back fitted amongst the various mechanisms. This may create distortions to incentives that reduce their effectiveness in tackling the undesirable effects of RPI-X and encouraging appropriate DNO behaviours.

There have been significant discussions in previous consultations on the package of total returns available under the DPCR4 settlement. Ofgem has focussed on the gains made by companies under the losses incentive mechanism. We suggest that these gains were driven by an inappropriate incentive design which was not aligned with the

desired behaviours. Two important points must be taken from this experience. There is an inherent danger of developing an incentive mechanism on the basis of simplicity of reporting or convenience as it will not deliver appropriate results. Whilst we agree that regulation should be kept as simple as possible, in certain cases the emphasis must be on the results rather than the clarity of the mechanism. It is also important to remember that the results of the losses mechanism rested upon the target setting process and the vagaries of the settlement process which is normally used for very different purposes. Therefore, gains made under this mechanism were largely uncontrollable, demonstrate a considerable year on year volatility and could have outturned very differently.

Ofgem should not place a cap or collar on the total available returns. Placing caps and collars on mechanisms where the DNO does not control its performance has the effect of minimising the risk associated with the measure but fails to recognise that the original incentive was put in place with a specific objective in mind (i.e. minimising electrical losses). We would suggest that if a mechanism is not fit for its intended purpose then it should be replaced with an appropriate model.

1 Low Carbon Networks Fund

1.1 Objectives and Behaviours

We have been consistently supportive of Ofgem's ideas in relation to the development of a Low Carbon Preparation Fund, but now find that the proposed cuts to cost allowances would create an environment in which 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. In theory the Low Carbon Network Fund (LCNF) should be a sensible initiative from Ofgem and is certainly of sufficient scale to encourage the required change. The introduction of new environmental measures is important to allow DNOs to move towards a low carbon economy.

The current energy market arrangements now contain a large number of companies occupying different segments of the supply chain and it will be necessary to create a shared vision and an innovative regulatory regime to generate the required momentum in the face of future uncertainty. DNOs will play an active part in the shift to a low carbon economy but success will rely equally on a range of other players.

Our enthusiasm for this sensible proposal is now tempered by our real concerns that we will not be able to employ the necessarily skilled and experienced people to put together any applications, given that this function is solely an indirect cost.

1.2 Incentive Mechanism

Subject to the caveat about overall affordability, we broadly welcome the framework set out in the Initial Proposals - Incentives and Obligations paper and recognise it as a significant step for UK distribution network operators and owners. It is clear that to provide the required step change in the level of low carbon related innovation delivered into our networks our industry will need support from many other organisations both from inside and outside government and these proposals should encourage the right level of interest.

The size of the proposed funding appears reasonable based on the perceived costs of installing a number of significant trials. It is believed the SmartGrid City Project in Boulder has achieved 25% DG penetration for a population of 100,000 at a cost of \$100m. This level of funding could potentially achieve 5 similar sized projects across the UK over the 5 year period.

It is clear that DNOs will all need to increase their internal resources to deliver the scale of projects in the time proposed and ENW welcomed previous Ofgem discussion papers which stated that an element of the LCN Fund can be used to develop this. Given the extent of the cuts to indirect costs proposed by Ofgem, much more clarity and certainty on the rules of cost allocation to and recovery from this fund will now be required if DNOs are to have the resources required to utilise the fund.

Furthermore, experience from IFI has shown that negotiations over legal and contractual arrangements (including discussions on IPR rights) have required a substantial investment in resources and the impact on project costs and timing needs to be included in the recovered costs.

We agree with the principle of discretionary awards but the mechanism, timing and qualifying criteria need to be made clear and in particular how smaller DNOs will have fair and equal access to discretionary awards. It will be important to ensure that larger, vertically integrated, DNOs having inherently greater resources do not have an unfair advantage over smaller or singleton DNOs (in that our in-direct costs have been overly restricted by Ofgem's current cost analysis and our resources are more limited). In addition, there is a potentially significant cash flow effect that needs to be considered as discretionary awards are only given annually.

Ofgem are developing the policy surrounding the LCNF in the period leading up to the Final Proposals. We suggest that Ofgem should consider the potential for carry over into DPCR6 as the fund is likely to produce long term projects which will probably cross regulatory time boundaries. Establishing these rules from the start of the fund will help DNOs to maximise the benefits of the mechanism.

ENW has long supported a two-tier approach to innovation funding in order to accommodate a more flexible approach to larger 'flagship' projects alongside more routine 'IFI sized' initiatives. We suggest that it is important to learn the lessons from the RPZ scheme. The principle and behaviours behind the proposal were appropriate but the specifics of the mechanism, particularly the restrictions on funding sources, reduced the likelihood of success.

We believe detailed guidance is required in the form of a new Good Practice Guide to cover the Tier 1 mechanism, detailing the eligibility criteria and reporting rules, etc. Unless the criteria are clarified there is potential for confusion between what can be classed as an IFI project and what will have to be classed as an LCN Fund Tier 1 project. This last issue will be influenced by how the funding of each mechanism works and needs to be clarified in order to avoid cherry-picking between the two mechanisms.

We believe 5 years is a very ambitious timescale to deliver the scale of projects being proposed. However, it should provide enough time to produce a clear indication of the success of the proposed fund.

We agree with the proposal to recognise that the risk profile of these types of projects is different from DNO 'business as usual', however, the mechanism is based on a clear definition of 'project benefits'. We feel this may be hard to define as it is partly based on future avoided costs from the 'base case'.

Basing the funding on the difference between the project costs and the direct benefits is likely to lead to ongoing debate as an assessment of project benefits is likely to be very subjective (based on experience with IFI), and will inevitably lead to lengthy discussions about the level of benefits and hence the funding required. This issue would be further complicated where other funding partners are involved and where, as is likely, the various partners have differing assessment of benefits. It may be worth

considering an alternative mechanism to simplify the bidding process, possibly by encouraging DNOs to bid for the amount of funding required to make the project viable. This will be broadly similar to the stated Ofgem intent, but less bureaucratic and the competition between DNOs for the central pot will ensure efficient bidding.

1.3 Balancing between Customers and DNOs

We believe the 90/10% risk split is appropriate based on the experience of IFI however discussion is required on the scope of the risk being considered. The success of a SmartGrid City type project would fundamentally rely on a range of factors outside the control of a DNO, for example a large-scale roll-out of smart metering with appropriate communications technology. If the final smart metering specification did not provide sufficient functionality then project costs could increase substantially as the cost of providing the necessary metering was added to the project.

In the short term (<5 years) these projects are likely to be a cash and profit drain on DNOs (not least) due to the considerable investment in and on-going maintenance of the required technology. Ofgem must recognise that in the face of substantial cuts to cost allowances, the whole scheme is rendered much less viable. Whilst we would agree with the principle that any benefits that result from the projects should be counted as part of the DNOs reward for successfully delivering the project however as stated previously, how the benefits and risks are defined at the outset of the project will require careful discussion and practical guidance.

We agree that the funding should operate on the same 'use it or lose it' basis as IFI and it appears appropriate that the funding should ramp up over the 5 year period.

1.4 Questions

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

Our response is contained in section 1.2

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?

Our response is contained in section 1.2

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

Our response is contained in section 1.3

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?

Our response is contained in section 1.3

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?

Our response is contained in section 1.3

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

Our response is contained in section 1.1

2 Provision of Information to Distributed Generation

2.1 Overview

We acknowledge that it can be difficult for prospective DG customers to understand the data information requirements associated with a network connection. This is particularly true for customers wishing to connect at the lower voltages who may not be technically literate in this area. However, we do not think that the inherent complexities should be interpreted as DNO unhelpfulness and there is no evidence to suggest that this is an issue that represents a barrier to connection. We agree that connecting DG domestically should be like any other domestic purchase. We believe that the DNOs could work with producers and retailers to minimize any efforts that customers have to take to comply with the legal duties on them under ESQCR. These type of activities are unlikely to be possible given the dramatic cuts in indirect activities proposed in the Initial Proposals

2.2 Information Requirements

The main barrier to the establishment of greater DG has been customers' difficulty in obtaining the necessary planning consents. We have always placed great emphasis on assisting prospective connection customers, as is demonstrated by our commitment to provide one consultant meeting free of charge for each enquiry. This kind of behaviour may, of course, have to end given the cuts to our indirect costs which indicate Ofgem don't want DNOs to provide such a service and are only prepared to fund the offerings of the lowest cost DNOs.

We believe that the LTDS should remain a technical publication targeted at the EHV network. Customers utilising this data for the purposes of design are required by the Construction (Design and Management) Regulations 2007 to be competent and will understand the information and its limitations. Furthermore, we agree that provision of this data for lower voltage networks would be expensive to provide and maintain. Notwithstanding this, we will look to work with Ofgem to understand how the present LTDS can be improved.

However, there is scope to improve information provided to customers to facilitate better understanding of the connection process and likely costs. We are actively contributing to the national work in this area, through the ENA's Regulatory Framework working group. Appropriate provision of this information will enable us to provide a speedier and more accurate response to the customer. The pre-filter stage will help reduce the number of unproductive enquiries and when the customer wishes to contact us this will be addressed as it is currently. A revised connections guide should be targeted at a working level and should include standard (across the industry) information and application forms.

We have commented on the standards of performance requirements that Ofgem is proposing within our comments on Chapter 10 on connections incentives.

We recognise that improvements can be made in the provision of generic data at the lower voltage levels and we are keen to work with Ofgem to understand and address this issue. We want to understand how Ofgem propose to obligate and incentivise our performance, and therefore strategy, in this respect.

2.3 Questions

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

Our response is contained in section 2.2

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

Our response is contained in section 2.2

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

Our response is contained in section 2.2

3 Distributed Generation Incentive Framework

3.1 Overview

Our base forecast for DG connections in DPCR5 is 1029 MW, the second highest of any DNO's prediction in the June FBPQ. In developing our base scenario, we undertook a detailed assessment of regional and national drivers and constraints on different types of DG connections. We thus have a detailed understanding of the type of range and uncertainty in DG connection volumes and costs. We took the opportunity to provide further information on this at the June Environment bilateral meeting.

As a result, we support the retention of the DG incentive framework as an alternative to an ex-ante cost allowance. It is as an effective way to manage these real uncertainties and to allow DNOs the funding to scale up their investment as connection volumes increase. The DG incentive framework does not enable trials of innovative approaches or system-wide changes in infrastructure; however the IFI and particularly the LCN fund may help to address these areas.

3.2 Detailed methodology points

For DG, we also support the change to the annuity formula for DPCR5 to recover 80% of the DNO's capital costs for DG (use-of-system capex) and properly reflect the 'shallowish' connection boundary. The change removes the current perverse dependence of return to the DNO on the level of cost apportionment factors. It also means that the DNO has 80% pass-through of its costs, as intended in the original design of the incentive, and this reduces the risk of use-of-system capex not being recovered.

We agree with the scale of the revised incentive rate of £1/kW/yr on the basis of this revised annuity formula giving a return of 1% above the pre-tax cost of capital at use-of-system capex $g_{ps} = £34/kW$.

We note that the final rate is subject to decisions on the cost of capital for DPCR5. However when the rate is finalised, Ofgem needs to clarify the price base before DNOs can fully understand its implications. If the rates were calculated on the same 2005/06 basis as employed for DPCR4, they need to be scaled up by an inflation factor for 2010/11.

We also agree with the scale of the O&M allowance for DPCR5. Again, Ofgem will need to confirm the price base before DNOs can fully understand its implications.

Section 3.25, note 17, states that the DPCR4 future revenue stream has been calculated using data in the June 2009 FBPQ, in order to set the overall cap and collar. As we have highlighted in our previous consultation responses, the FBPQ asked for information to be reported as regulatory directs only, rather than statutory directs as specified in the DG RIGS and applicable to the DG incentive framework. Thus care must be taken in using the FBPQ figures to determine an income allowance. Reporting

by DNOs in the annual return at the end of July is against the appropriate DG RIGS definitions for the incentive.

We also agree with the scale and continued use of a high-cost threshold in the connection boundary for DG. Retention of the threshold at around this level is important for managing the asymmetric cost risk in NPV terms of defining the caps and collars on return in terms of IRR. However Ofgem should again clarify the price base and that the high-cost threshold of £200/kW refers to total statutory non-sole-use reinforcement cost for a specific project.

3.3 Application of the cap and collar

3.3.1 Extending the time period for analysis

We propose that Ofgem extend the time period for assessment of the cap and collar on return to the DNO, to cover cashflows in both DPCR4 and DPCR5. This would reflect a more representative group of projects and would better enable and encourage investment by DNOs in reinforcement for future DG.

In DPCR4, many DNOs will be at or near the cap on returns from DG, based on a small portfolio of relevant DG at low reinforcement costs. One reason why the portfolio is artificially small and cheap is the long timescales from application to connection of DG projects, particularly those including reinforcement. This is marked because there was a rush of applications by generators in the closing months of the 04/05 financial year to avoid GDUoS charges that were introduced for applications post 1 April 2005. This has meant that many reinforcement projects for DG during DPCR4 are non-relevant, so therefore excluded from the analysis. In addition, early projects will seek out sites with spare network capacity and low connection costs. Average forecast costs were always likely to be influenced by a small number of higher cost projects, and these have not generally progressed from application to connection within the DPCR4 timescale. Furthermore planning policy and levels of economic support for DG have meant that overall DG connection volumes have remained low.

If the cap and collar are assessed solely on relevant DG connected in the DPCR4 period, DNOs above their cap will simply reduce/ repay GDUoS to currently connected DG in order to bring them in line with the cap. This is rather than investing recovered revenue to facilitate future DG, whereby DNOs could take opportunities to invest in reinforcement and spare capacity which they thought would be used, so that they could earn a return within the cap/collar boundary but on a larger investment.

This longer timescale for assessment also better reflects the longer timescales of reinforcement projects. It would encourage strategic investment where DNOs assessed that generation could be encouraged, because the DNO would have a longer time period during which generators could connect and the DNO could thus benefit. It would be fairer for customers to bear the costs of the DG incentive when applied to a more representative portfolio of relevant DG projects over the full DPCR4 and DPCR5 time period.

3.3.2 Treatment of LV connections

Our proposal to extend the time period for assessing caps and collars should reduce the risk of zero reinforcement costs and hence infinite IRR being reported. However we are concerned by Ofgem's suggestion that DNOs should receive zero incentive income in the case of zero reinforcement cost.

This seems to be a perverse interpretation of the incentive on DNOs to reduce reinforcement costs to DG. Furthermore, when a DNO has reached the cap on its returns, there is no further financial benefit to the DNO if reinforcement costs are further reduced. The combined effect is that there is not a 'DG incentive' for low-cost projects. This is not an encouragement DNOs to be 'proactive and positive in responding to connection requests' which was a stated objective of the original scheme.

Every new connection adds to the DNO's overhead costs, particularly with increasing requirements on DNOs to provide information and assistance to DG connections, especially small customers at LV. If there are no capital works for sole-use or reinforcement assets, then these customers do not contribute to this overhead in connection charges. If there are no reinforcement costs, customers in general do not contribute via use-of-system charges. However the DNO's costs increase. The more generators the DNO interacts with through their connection processes, the more its costs increase.

This problem could be resolved by separately identifying revenue under the DG incentive based on the kW of relevant DG connected at LV with zero reinforcement costs, and excluding this revenue from the cap/collar calculation. This would only require one additional item of information to be reported by the DNOs to Ofgem.

We estimate that if 30MW of LV generation connects at zero reinforcement cost over the five-year DPCR5 period (out of 1029MW of DG connecting in our base scenario) this would have a value of approximately £275k in NPV terms over the lifetime of the incentive. This is still modest in the context of overall DG capital expenditure, but would correct the perverse financial incentive which currently exists for DNOs being proactive with this particular customer group.

3.4 Question

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?

See 3.1 to 3.3 above.

4 Use of System Charging to pre-2005 Connected Distributed Generation

4.1 Question

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?

We agree with the Ofgem proposal to terminate the blanket exemption from use of system charges for pre-2005 connected Distributed Generation. Our review of connection agreements supports the Ofgem analysis that whilst pre-2005 generation may have evergreen rights to connection, which is consistent with all customers and the Electricity Act, they do not have rights to be exempt from charges.

We expect that 11kV connected pre-2005 generation will be covered by the CDCM from 1 April 2010. For EHV connected pre-2005 generation we propose to continue the current arrangements for 2010-11 in line with the general approach of minimal change for all EHV customers, as discussed with Ofgem. An EHV charging modification proposal to this effect was submitted to Ofgem on 1 September 2009. We propose that all EHV generation will be included in the EDCM which will take effect from 1 April 2011.

5 Transmission Exit Charges Incentive

5.1 Overview

We maintain that it is unnecessary and inappropriate for an incentive to be applied to the DNOs in respect of Transmission Exit Charges. We do not believe that the proposed incentive arrangement will deliver the desired behaviours.

The reality is that the long lead times associated with new GSP schemes mean the choice of engineering solution is usually made in advance of the price control period when the investment is to be made. Thus, an incentive based on the estimated costs of actual schemes can only incentivise the efficient delivery of those schemes (which is within the control of NGET rather than the DNOs) and not the choice of engineering solution, which the DNOs can and already do influence.

In terms of influencing, we have discussions on a number of levels with NGET to ensure that “value for money” investments are made. These discussions revolve around both the engineering solution and commercial arrangements. For the one project in our GSP group that is for reinforcement in DPCR5 we have provided Ofgem with additional information in terms of GAV and exit charge values, plus a “needs statement”. We would be happy to provide further details of the engineering solution in terms of asset details and asset volumes, so that a view of efficient investment can be taken.

Ofgem’s proposal does not incentivise the delivery of efficient technical solutions at exit points; rather, it rewards or penalises the long term forecasting accuracy of DNOs. DNOs are in turn reliant on NGET accurately forecasting GAVs, which will inevitably change as schemes progress to completion. For some schemes in the later years of the price control no “variation to bilateral” agreements may yet exist, so forecasts will be rough estimates at best.

The Ofgem intention to introduce an incentive mechanism requiring DNOs to expend more in-direct costs in monitoring and negotiating with NGET is in direct conflict with your approach to setting in-direct cost allowances, which drives DNOs to minimise such costs and only provides funds associated with the most minimal level of activity by the DNO groups.

As stated in previous responses, exit charges are largely outside the control of DNOs, and the annual charges can be volatile especially when new or reinforcement assets become chargeable. This makes it difficult for DNOs to accurately forecast ahead, even when contact with NGET is frequent. Such volatility has the potential to create windfall gains and losses within the incentive, rather than achieving Ofgem’s desired effect.

Furthermore, introducing DNO exposure to this risk could have the effect of increasing charges. For example, on 5th November 2008, NGET published an Open Letter to the Industry, entitled Offer Pricing Options, which inter alia gave the option of fixing charges very early in a GSP project, rather than going with indicative prices followed by a reconciliation process. The fixed charge option would obviously carry higher risk

premium and in our view produce higher overall charges. However it would produce certainty, which the DNOs might value over cost efficiency in view of their exposure to accuracy of forecasts under the incentive scheme.

In terms of the detail of the incentive we would like to understand how the 20% sharing factor outlined in paragraph 5.13 has been derived? We do not believe Ofgem have as yet collated enough data to allow an assessment of efficient expenditure at Grid Supply Points, so we would propose that for this price control period the percentage should be reduced. The strength of the incentive could be reconsidered at a later date in the light of further information.

Although Ofgem (paragraph 5.16) have stated that a provisional modelling assumption has been made based on DNO FBPQ forecasts this appears to be missing from the financial model. This needs to be put right in subsequent versions.

5.2 Questions

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

We do not agree that the proposed hybrid approach is necessary or appropriate, for the reasons outlined above.

Ofgem's proposal does not incentivise the delivery of efficient technical solutions at exit points; rather, it rewards or penalises the long term forecasting accuracy of DNOs. DNOs are in turn reliant on NGET accurately forecasting GAVs, which will inevitably change as schemes progress to completion. For some schemes in the later years of the price control no "variation to bilateral" agreements may yet exist, so forecasts will be rough estimates at best.

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

We do not agree that the exit charges incentive proposal is either necessary or appropriate; hence the answer is no.

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

Notwithstanding our answers to Questions 1&2, we believe that if an incentive is put in place, then for this price control period the percentage should be less than the proposed 20%. The strength of the incentive could be reconsidered at a later date in the light of further information.

6 Losses Incentive

6.1 Overview

We have provided your 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. However, if an output scheme is to continue, we believe that the DG excess loss adjustment must continue to form an essential part of the package, if there is not to be a complete undermining of the DG incentive in a large portion of our network.

We also note that you have recently developed a new version of the losses roller mechanism which renders all rewards and penalties subject to performance in a single year, in direct conflict with the purpose of such rolling mechanisms. We can only speculate that the willingness to expose DNOs to such risks, alongside the drive to set tighter targets and increase the incentive rate such that all DNOs feel they are very likely to incur severe penalties, is a response to a perception of inappropriate gains being made during DPCR4. If specific DNOs have abused the system it would be far better to investigate their behaviour than to increase risk for all DNOs and their customers.

We agree that a technical model would be too complex and probably unrepresentative of an individual DNO's network to be a practicable solution.

Ofgem recognise some of the deficiencies of the existing output scheme but do not offer proposals to address the settlement issues that concern DNOs. These concerns revolve around for example meter accuracy, unmetered supplies, energisation status, erroneous EA/AA values – ie many of the issues highlighted in recent BSC audits. Due to the very nature of the output based calculation, ie the relatively small difference between the two very large values of system entry and system exit volumes, errors that occur as highlighted above can have a material impact on the incentive outcome. Ofgem have done little to address these ongoing concerns.

The proposed two year lag will improve the allocation of units distributed to the correct regulatory years, however it will not address the underlying settlements concerns that we have.

We challenge Ofgem's view that we should be more proactive in targeting theft of electricity. We set out again later in our response the actions we have taken during DPCR4 to address theft. We continue to urge Ofgem to address the underlying deficiencies that Suppliers face, that effectively act as financial barriers for them when faced with cases of theft detection. We also note that the types of activity Ofgem wish to see and that we are currently engaged in will drive up indirect costs. Ofgem's

approach of penalising companies who incur this expenditure and drive to determine the minimum level of indirect costs appears to act against such initiatives.

6.2 Key Issues in Development

We are disappointed that Ofgem have proposed an output scheme, with only limited recognition of the benefits of an input scheme.

We agree that a technical model would be too complex and probably unrepresentative of an individual DNO's network to be a practicable solution.

Even with greater involvement, DNOs' influence within Elexon, on suppliers and their data agents will be at best limited. Suppliers will always make a judgement call between the cost of data collection/handling and the accuracy and timeliness that they need from such data.

We do however expect to request through the ENA's Commercial Operations Group the appointment of a DNO representative to Elexon's Performance Assurance Board (PAB). In terms of general data quality, we feel we are particularly strong in the areas of Unmetered Supply Management and the proactive detection of electricity theft. The key issue is for detected theft units to be entered into settlement by suppliers.

When setting the DPCR5 losses target the timing of the target adjustment in respect to explicit low loss investments must coincide with the associated commissioning schedule.

6.3 Common Reporting Methodology and Lag

We have consistently argued that an input based mechanism is a more appropriate mechanism to incentivise losses. However, if an output mechanism is to be retained, we support the adoption of a common reporting method that does not include the use of provision accounts.

The introduction of a two year lag in reporting will help to align units exiting the network against regulatory year; it will not however deal with the underlying volatility of settlements data. Metering inaccuracy, energisation status issues and erroneous EA/AA values are just three of the factors that will still continue to make settlement data inaccurate.

In general we support Ofgem's proposed methodology as it reflects, in most respects, the methodology already in use within ENW. One significant difference however is that we report flows at GSP points on a net basis (using IO30 data flows) rather than gross as Ofgem propose. This has two advantages:

- The calculation of units exiting the network, being based on gross flows at all exit points other than GSPs, is reflective of units billed (or to be billed).
- If GSP flows are reported gross, then the volumes have the potential for greater volatility, which will not in itself change absolute losses, but will affect

the calculation of the target percentage. This is because GSP export is generally the result of increased output from embedded generation and does not represent increased network demand.

For DNO to DNO connections and BMU embedded generation sites, we support the “bottom up” approach of using the IO12 and IO14 data flows. This needs to be carried out on a site-by-site basis, with particular care being taken over the application of the aggregation rules, particularly at sites where the meters are registered by 3rd parties. We believe that this issue may be a possible source of the disparity between Ofgem’s initial analysis of units entering and exiting ENW’s system, and our own.

We support Ofgem’s proposal to use the D0030 and D0275 data flows for SVA entry and exit volumes.

We make specific comments on substation usage and the DG excess losses adjustment later in this chapter response.

6.4 Targets

Ofgem propose to update years based on receipt of a full years worth of RF data. We believe that this is a sensible step forward but Ofgem must recognise that ensuring that reported data appears in the correct financial year will not resolve the issue of volatility. We suggest that the most important aspect is that a consistent reporting line is drawn for all companies and that the losses targets reflect the same methodology (including energy used in substations and DG Excess losses). It is important to recognise that the targets published as part of the Final Proposals will not contain fully corrected data, adding additional risk to the price control package.

We support the option of setting targets based on currently available data. This will eliminate the uncertainty that is inherent in the second option, although we agree that this is probably not an issue if the two year lag is to be introduced into reporting; hence, later revisions could be made for RF data although we note that DF runs are not included. The key issue at this stage is to agree the detailed methodology for the incentive and its targets by testing the actual calculation on a sample of historic data.

As mentioned above, when setting the DPCR5 losses target the timing of the target adjustment in respect to explicit low loss investments must coincide with the commissioning schedule.

6.5 Incentive Value and Rolling Retention Mechanism

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. The incentive rate (derived from the shadow price of carbon plus a view of the delivered cost of electricity) would be entirely appropriate for the proposed input based approach but we believe it is increasing risk for the DNOs in the output mechanism, which incentivises dataflow management and theft reduction. If the incentive rate is designed to price the

externality, data filtering should not attract a similar rate to real carbon reducing activities.

With regard to the losses rolling retention mechanism, we have significant concerns that the net reward/penalty generated by the DPCR4 incentive and its associated roller (ie in total across the DPCR4 and DPCR5 periods) is driven entirely by the amount reported for DNO performance in year 5 of DPCR4 (2009/10).

Given the acknowledged volatility underlying the losses return, it is totally inappropriate that the combined effect of the incentive and the roller should be driven by the snapshot of reported performance in 2009/10. It effectively renders the performance in the first four years of DPCR4 irrelevant, and actually magnifies the level of risk already inherent in the output scheme, for both DNOs and customers.

We support Ofgem's Option 1 (switching off the DPCR4 mechanism) and suggest that a roller should not come into operation until all DNOs apply common methodologies. If, however, the mechanism is not to be switched off, we would maintain that the basis of the roller calculation must be the average DNO performance across DPCR4 rather than the year 5 performance.

6.6 Cap and Floor

Ofgem has recognised the level of volatility contained within the losses incentive mechanism and is proposing to apply a cap and floor. We believe that this is a sensible approach but it is dependent upon the width of the band. It is possible that the width of the band will not help with the potential year on year volatility. We therefore suggest that Ofgem use annual caps and floors to limit customer and DNO exposure to any one year's abnormal results (which a five year cap/collar would not necessarily constrain). It may also be appropriate to use a cashless incentive mechanism for DPCR5 where all revenue adjustments are logged up and finalised as part of DPCR6. We believe that this will also help to ensure that the majority of data appears in the correct reporting period.

6.7 Substation Usage

We welcome the addition of the adjustment for non settlement exit volumes to IDNOs but maintain that an equivalent adjustment should continue for the substation usage, as these GWhs are not genuine losses.

We are concerned that classifying substation usage as unmetered will not fulfil the requirements of BSCP 520 (Unmetered Supplies Registered in SMRS) whereby only exit points with an electrical load of a predictable nature should be considered.

As far as funding is concerned we were unaware of Ofgem's request to include the costs of paying for substation electricity within the FBPQ. The estimated funding required is circa £1.3m pa.

6.8 The DG Excess Losses Adjustment

At DPCR4 an issue was identified relating to the impact on the losses incentive of large and/or multiple generation schemes locating or clustering in remote locations. The risk was identified that the adverse impact on losses could more than offset the benefit of the distributed generation incentive scheme. Ofgem considered at that time that some form of limited protection was appropriate; however this protection appears to have been discontinued (without explanation) for DPCR5.

The issue arises typically where large EHV generators of many MW connect to remote networks, causing increased power flows and therefore increased losses. Such large scale generation is frequently renewable, eg windfarms, and therefore the associated losses are relatively less damaging, being supplied from a low-carbon source.

It should be noted that the generators themselves are already exposed to the cost of losses they cause, through the application of Loss Adjustment Factors to their output in settlements. If, despite this cost incentive, they choose to locate at a remote site (because of a local renewable resource) then the DNO will suffer an unjustified direct financial penalty in specific areas where generation exceeds demand.

Given that the growth of generation predominantly involves low-carbon sources and given the regulator's sustainable development duty, this would be the wrong incentive for Ofgem to give to DNOs. Specifically, ENW would be faced with a quantifiable disincentive to connect DG to its 132kV network in Cumbria, one of the regions richest in renewable resource within our area. Arguably, the cost penalty should be lessened rather than placed in full on the DNOs

DNOs can not recover the cost penalty from the generators which cause the losses unless their allowed revenue is adjusted. The penalty can only be compensated for within the losses mechanism itself, which would in turn feed into allowed revenue and hence overall use-of-system charges.

We consider that the DG-excess-loss adjustment, similar to that in DPCR4, should continue in DPCR5. This could readily be included in the common reporting methodology or as an explicit adjustment to incentivised losses in the special licence condition. This would also aid target-setting, in that the adjustment would be applied consistently across DPCR4 and DPCR5.

6.9 Questions

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

We support Ofgem's proposal to provide explicit funding for low loss investments. The timing of the losses target adjustment should align with when the low loss equipment comes into operation.

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

A two year reporting time lag will more accurately allow units to be aligned to regulatory years although it does not in itself improve accuracy. Data settlement inaccuracies will still continue to exist, examples being metering accuracy, unmetered supplies, energisation status, erroneous EA/AA values – ie many of the issues highlighted in recent BSC audits.

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 proposal and the flexibility of SVA data flow usage. For CVA data flows we support the hybrid approach for GSP entry values, for the reasons detailed above, and the bottom up approach for the rest of CVA.

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

We have no specific comments to make on either the value of the incentive rate, or the intention to continue to use the rolling retention mechanism, although we comment on the detail of the latter in our response to chapter 7.

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 are concerned that classifying substation usage as unmetered will not fulfil the requirements of BSCP 520 (Unmetered Supplies Registered in SMRS) whereby only exit points with an electrical load of a predictable nature should be considered.

As far as funding is concerned we were unaware of Ofgem's request to include the costs of paying for substation electricity within the FBPQ. The estimated funding required is circa £1.3m pa.

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

We support Ofgem's proposal to remove the cap from the losses incentive if any DNO is able to identify a more appropriate method of losses measurement. Although the proposal is well-intentioned, it should be recognised that the "more accurate" losses

measurement methodology may result in higher reported losses with possible negative implications for the DNO.

7 Treatment of DPCR4 Losses Rolling Retention Mechanism

7.1 Overview

The rolling retention mechanism described in the November 2004 DPCR4 Final Proposals is different from the interpretation Ofgem now seem to have adopted. Whilst only a broad description was provided at that time, and the formulae underlying the worked example in the document were not made explicit, it seems absurd that any rolling incentive would have the effect of rendering all rewards and penalties dependent on the performance in a single year.

The question of how the mechanism should be implemented was discussed at the Environment Working Group. One clear issue to emerge from this discussion is that the combined net effect of the cashflows generated by the DPCR4 incentive and its associated roller (ie in total across the DPCR4 and DPCR5 periods) is driven entirely by the amount reported for DNO performance in year 5 of DPCR4 (2009/10).

Ofgem have acknowledged, both at the EWG and also in the chapter on the losses incentive, that there are issues with the quality and volatility of the data on which the current output incentive is based and have proposed a number of steps for DPCR5 in order to address this; however these proposals do not extend to smoothing out the volatility that is apparent between the reported performance for the individual years of DPCR4.

Given the acknowledged volatility underlying the losses return, it is totally inappropriate that the combined effect of the incentive and the roller should be driven by the snapshot of reported performance in 2009/10. It effectively renders the performance in the first four years of DPCR4 irrelevant, and actually magnifies the level of risk already inherent in the output scheme, for both DNOs and customers. This is not the interpretation of the scheme gained from discussion with Ofgem at the time and the basis on which we accepted the Final Proposals for DPCR4.

It is now apparent that Ofgem have found it acceptable for DNOs to apply different loss calculation methodologies during DPCR4, in particular different types of adjustments (eg provisions, unsettled data etc). This supports Ofgem's Option 1 (switching off the DPCR4 mechanism) and that a roller should not come into operation until all DNOs apply common adjustments; otherwise the roller just compounds the inequality that is embedded in the DPCR4 losses incentive scheme itself.

If, however, the mechanism is not to be switched off, we would maintain that the basis of the roller calculation must be the average DNO performance across DPCR4 rather than the year 5 performance. This could be derived as the average of the first 4 years of DPCR4 if the calculation is to be performed now, or carried out later as the average of the full 5 year period. The former approach would appear to reflect the worked example in the DPCR4 Final Proposals, whereas the latter would more closely reflect the principle of applying the roller to the full DPCR4 period. The latter approach is possible because the roller calculation is independent of the target setting, and indeed the choice of incentive mechanism, for DPCR5.

If the mechanism is to be implemented in the form suggested by Ofgem, we have the following comments on the detailed workings. The mechanism as it currently stands does not take account of the change in the target percentages that occurred part way through DPCR4. Our target was tightened from 5.68% to 5.48% in 2007/08 as the result of our identifying and reporting to Ofgem an error in previous years' reports. Since the roller relies entirely on performance measured against the 2009/10 target, we believe that it would be equitable to use the level of target that would have been set originally for the whole of DPCR4 if that reporting error had not occurred. We calculate this value to be 5.58%.

7.2 Questions

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?

We fundamentally disagree with the proposal to base the roller on a single year's performance, particularly when there are such a wide variety of approaches amongst DNOs to the underlying incentive calculation. The inclusion or otherwise of settlements corrections does not alter our view on this principle.

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 support Option 1, the switching off of the DPCR4 roller.

We do not believe that Option 2, the buyout option, will be practicable. Ofgem's Table 7.1 shows a range of outturn performance for ENW of approximately £10m under two possible scenarios of 2009/10 performance. Analysis of historic volatility in losses performance suggests that the range could be at least double this level. Under these circumstances it is difficult to see how a common view of the likely outturn can be established in order for a price to be set that is acceptable to both the DNO and customers.

8 Business Carbon Footprint Reporting

8.1 Overview

We support the principle of Business Carbon Footprint reporting and we want it to be as useful as possible. We further recognise that the reporting would develop over the first few years as all DNOs gained more experience. We have already pioneered this reporting in DPCR4 and note that we are to be penalised for incurring indirect costs associated with activities that lead the industry in this way. We also note that Ofgem make no mention of ensuring that DNOs can recover the costs of this or many of the other new activities proposed in this document.

There needs to be consistency of approach across DNOs at each stage of this development however, and therefore a reasonable level of guidance from Ofgem as to what should be included in reports. For example, we not sure why Ofgem have left it to DNOs' discretion as to whether fuels are converted to kgCO₂e on a net or gross calorific value, 1.11 Appendix 5) rather than of fuels (note 2.2) and allocation of substation usage (note 2.3).

We are also conscious of the need for proportionality in terms of the both the level of detail required in reports and the extent to which data is required from a potential chain of contractors and sub-contractors. Obtaining Scope 3 data from small sized sub-contractors who do short duration small works, could be problematic. Due to the comparatively small value of such work, the requirement for the contractor to provide figures may dissuade the smaller companies from tendering for the work. It would not be proportionate for overall projects costs to go up for the sake of obtaining information whose sole use would be to populate a league table.

Similarly, the level of detailed data required for each category of emissions should take into account the relative contribution of that category to the overall carbon footprint. It seems appropriate at this stage to focus on the more significant contributions to carbon emissions rather than putting a lot of resource into gathering data on less significant issues. Specifically, the breakdown of transport into such detail (1.13 – 1.5 Appendix 5) seems inappropriate in view of the relatively small effect of using anything other than overall average conversion factors.

In the key area of losses however, it is possibly over-simplistic to report on the basis of the “Grid Rolling Average Conversion Factor” alone. If each DNO were to construct a weighted average factor, based on the relative proportions of units entering the system from Grid sources and “zero-rated” embedded renewables respectively, this would demonstrate the significant impact over time of such embedded DG. This calculation might be kept quite simple, focussing solely on exports from embedded renewables rather than more complex analysis of the full range of DG technologies, but would serve to demonstrate the significance of losses and renewable-based DG compared with the effects of other operational activities.

8.2 Process

In order to align with other regulatory reporting, ENW would expect to report on a financial year, April to March. We suggest that a 4 month period be allowed for the preparation of reports, so as to efficiently align with annual regulatory losses and revenue reporting.

8.3 Questions

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

We agree with the principle of BCF reporting, and in general terms the resources necessary to report BCF performance are already well established within ENW. We believe that due regard must be given to consistency and proportionality as reports develop over time.

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

We agree that Ofgem have focussed on a sensible set of overall categories for BCF reporting. We make a couple of points on the detail above, where we believe that consideration of issues of proportionality would lead to a modification of the detailed reporting rules.

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

At this stage we agree that a direct financial incentive on reducing the carbon footprint of a DNO's business operation may be premature as the first challenge is to provide a reliable and consistent data set. As these measurements are relatively new and data availability and breakdown is not homogeneous across DNOs any measured "reductions" could be due to data cleansing and improvement of measurement methodologies rather than actual reduction of GHG emissions. These issues should also be taken into account in the interpretation of early league tables.

In the longer term, once a track record of consistent data has been established, it may become appropriate to consider the provision of some form of financial incentive for the collection of data and achievement of continuous improvement.

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

9.1 Overview

We welcome the continuation of the undergrounding scheme and the clarification of the eligibility of proposals for inclusion. In particular, we welcome the ability to flex allowances to accommodate schemes of higher unit costs, and the facility to use the provision to 'top-up' other works. We confirm our intention to continue with this programme in conjunction with our regional partners, and already have a significant volume of work in progress.

We are glad that Ofgem have addressed the issue of DPCR4 carryover and clarified that overhead line removal can be carried out in 2010/11 from the DPCR4 allowance. This will be appropriate in areas where we may wish to leave the overhead lines in situ for a short while, based on local wildlife or agricultural considerations.

9.2 Questions

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

Our response is contained in section 9.1

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

Our response is contained in section 9.1

10 Connections Incentives and Obligations

10.1 Overview

We welcome Ofgem's acknowledgement that there are different levels of competition across DNO regions and the Ofgem's intention to introduce incentives for DNOs to be proactive in facilitating competition. We have some concerns that proposals Ofgem have made do not fully support this intent and do not sufficiently recognise DNOs such as ourselves that have been proactive in supporting key Ofgem strategic objectives prior to any such specific new incentives being introduced. The Ofgem approach to cost allowance setting actually penalises ENW in that it makes no recognition of the additional costs of design associated with a more active Independent Connection Provider community of stakeholders.

10.2 Proposed Guaranteed Standards Regime

Whilst we appreciate that Ofgem have developed the proposed standards regime against a backdrop of expressed customer dissatisfaction we have some concerns over the standards.

The proposals introduce 33 new standards (25 covering metered and 8 unmetered) and we are concerned that this is a disproportionate amount compared to the number of other guaranteed standards covering the rest of distribution activities. We do not consider that Ofgem has given sufficient consideration of the impact of these in DNOs where a competitive market exists. We believe that Ofgem need to satisfy itself that placing an obligation on DNOs (but not on any ICPs) to provide guaranteed levels of service and payments for any failures does not cause any distortion of the market either from the burden on the DNO or the perceived benefit to the customer.

We note Ofgem's intention to make DNOs agree to make payments to all customers as a condition of the price and service tests despite the legal constraints. We accept in principle that we would not wish to preclude payments to what we would consider as valid applicants if we fail to deliver to any agreed standards and are happy to work with Ofgem to develop such definitions that may be necessary.

Ofgem's intention with regard to services provided to ICPs in support of the competitive connections market is not clearly expressed. We would not consider it appropriate for payments to be introduced to the existing SLC 15 regime.

We are pleased to note that Ofgem are proposing that for unmetered work then the standards will not apply if other separate commercial arrangements exist. This allows us to continue bespoke bilateral arrangements that are in place and working well with particular local authorities.

We note Ofgem's comments regarding the development of price accuracy and are happy to work with Ofgem to develop suitable proposals.

10.3 Ofgem Proposed Penalty Methodology

We believe Ofgem should consider a mechanism to turn off the obligation. In the situation where a competitive market exists (evidenced by passing the Competition Tests) then we believe that the market will drive customer service. Retaining this degree of regulation where competition is proving the best protection for customers is counter to Ofgem's stated principles. We accept that this principle should only apply where the "pure competition tests" characterised by loss of market share are passed. This would act as another incentive for DNOs.

We believe that caps should be applied to these standards commensurate with the caps that exist in the similar guaranteed standards that apply in gas. We see no reason why the same principles that apply in gas are not extended to electricity.

10.4 Performance Targets

We consider Ofgem's proposal to have a licence condition based on a 90 percent performance target to be reasonable. We accept that reporting on the performance quarterly is reasonable and consistent with SLC15 but believe that the performance against the licence condition needs to be measured annually. Particularly on the first six months bedding in of any such new obligations, DNO face a risk of licence breaches which has implications for margin retention. Individual customers affected would clearly be recognised through the individual payments to them and we believe the monitoring by Ofgem will provide a strong enough incentive for improvement should any DNO be in that situation without making it a formal licence breach.

10.5 Competition and Margins

We are broadly supportive of the segmentation proposed by Ofgem. We are concerned that the treatment of larger street lighting schemes is unclear. The exclusion of new local authority connections where there are more than 50 jobs from Table 10.2 would appear to be an omission and we would consider these to be jobs that DNOs could earn a margin.

We do not feel able to comment on the level of proposed margin as the basis of calculating it is unclear. Ofgem make reference to a methodology (footnote 48) but it is unclear whether this is the methodology proposed and how it would be defined.

Ofgem's proposal that margin will not be allowed on indirect costs also has the effect of reducing the size of the incentive and its reason for doing so is unclear. We believe this will add complexity rather than simplicity to the calculation of margin and appears to remove any incentive for DNOs to reduce indirect costs associated with connections. Clarity on the treatment of over and under recovery of indirect will be needed.

We do not agree that connections are a low risk activity because they are fully funded up front. Whilst this may be true in principle, our experience is that customers prefer to have fixed priced quotations. We are therefore exposed to the risk of cost overruns on particular projects.

We are concerned that some of the hurdles that Ofgem have proposed or implied will act as a delay to when DNOs can retain a margin. In particular, the proposal states that DNOs cannot be assessed against price and service test until April 2011 and for some segments such as EHV this is the only proposed route to pass the competition tests. Whilst we appreciate that Ofgem need to put in place suitable thresholds for DNOs that are just starting the “transition to effective competition” we believe it undermines the principle of rewarding DNOs who have already been proactive. Similarly, we recognise the need for improve data and systems but we are concerned that compliance with detailed information request that are not as yet developed will be required before margin can be retained.

As you are aware any margin, even if as a result of over recovery, results in a reduction to our RAV. We believe that Ofgem should consider mechanisms for DNOs who can demonstrate the progress made towards the principle of effective competition that this adverse effect is suspended. We believe that this should apply for such years in DPCR4 as the DNO can evidence their support of an active competition in connections market.

We believe that a pure competition test is appropriate and 70 percent market share retention by the DNO is appropriate. This was used by Ofgem as the threshold for introducing competition into the supply market. We believe that this provides a suitable and appropriate precedent for connections.

Where the DNO market share is greater than 70% we can see some merit in further discussion with Ofgem. We would expect the level of evidence that a DNO would need to provide to substantiate their case where their market share was 71% compared to 99% would be significantly less. We recognise that having too many levels of subjectivity in the test could be disadvantageous to all parties but are happy to work with Ofgem to consider this through the ECSG workgroups.

10.6 Questions

Question 1: Do you agree with the scope, timeframes and the level of penalties proposed for the guaranteed standards regime? Please refer to sections 10.1

Our response is contained in section 10.2

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

Our response is contained in section 10.3.

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

Our response is contained in section 10.3.

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?

Our response is contained in section 10.4

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?

Our response is contained in section 10.5.

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?

Our response is contained in sections 10.5.

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

Our response is contained in sections 10.5.

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?

Our response is contained in sections 10.5.

11 Broad Measure of Customer Satisfaction

11.1 Overview

We have been supportive of the development of a Broad Measure of Customer Satisfaction until we were presented with the sizeable cost challenges contained within the Initial Proposals. The restrictions on responding to customer needs and enquiries imposed by such a cost cutting regime would render it very difficult to maintain positive engagement with customers. If these proposals are not substantially altered, we will have to withdraw our support for the scheme and the exposure of a further 1% of our revenue. We support, in principle the broader approach to measuring customer satisfaction as the current telephony measure is too narrow. However, a number of our comments in February 09 to your policy consultation reflected the need for appropriate measures to be developed and the potential difficulty in using an advocacy measure for a monopoly business. In a sense, those comments can only be repeated as your consultation accepts that most of the measures and attributes still need to be developed in conjunction with the industry. Progress has been made in that the three elements of the measure have been agreed and it is the details of the elements that have to be developed and we therefore agree that this scheme should be piloted for two years. Our specific comments are based on each of the proposed elements:

11.2 Customer satisfaction survey

The survey methodology considerations must include regional bias, sample sizes and those companies that are vertically integrated. You refer to possible alternative approaches in paragraph 11.3, though we have some difficulty in distinguishing between asking a respondent how he/she feels about the DNO following the contact experience or whether they would speak highly or critically of the DNO following that experience. Do not the two alternatives virtually amount to the same thing? Whilst asking customers about a monopoly business is slightly different, the essential components of "how a customer feels" is not substantially different to how a customer feels in their experience in shopping at Tescos, booking and experiencing a flight with an airline, or perhaps requiring assistance from an A&E unit at a hospital. Ofgem and the industry can no doubt consider the sort of surveys in such circumstances. The four criteria Ofgem have outlined in paragraph 11.8 could be applied in any of the above circumstances though we suspect the response to the second of the criteria will be very much interwoven with the first criteria. We have no objection to website information being considered as an important form of communication and we would suggest that for a DNO it will be a more important form of communication together with written and telephone contacts compared to face-to-face contacts.

11.3 Complaints metric

Clearly, the availability of complaints data will provide objective evidence for Ofgem. As discussed at a recent meeting with Ofgem, we would have thought that Ombudsman cases would be a more realistic criteria rather than Ofgem determinations which are a

very small percentage of complaints that are dealt with by DNOs. The complaints data that DNOs are sending to Ofgem by mid-October will be a useful guide.

11.4 Stakeholder engagement

We have been extremely proactive in seeking the views of customers and stakeholders during the whole of the DPCR5 process and we will be holding our fourth stakeholder event to consider Ofgem's initial proposals in Manchester on 3 September. We therefore support this element and will continue to work with our stakeholders to develop and enhance our relationship further. To this end we believe Ofgem should encourage DNOs through the incentive to develop a communication strategy and communication plan that will not only address the needs of different audiences within the stakeholder group, but will also facilitate two way feedback that will enable DNOs to seek suggestions and understand the impact of their activities. DNOs should be encouraged to monitor the effectiveness of their engagement activities through regular measurement that will enable DNOs to develop clear action plans, to aide continuous improvement in the relationship with their stakeholders.

11.5 Revenue Exposure and incentive weightings

In light of the proposed cuts in indirect costs for DPCR5, we find it difficult to support any exposure to an incentive mechanism where Ofgem fail to provide sufficient allowances to maintain the current level of performance. This is another example of Ofgem encouraging appropriate behaviours but producing a mechanism which fails to support them. We are also concerned that many of the details of the scheme have to be finalized and that the final drafting of the scheme for the licence conditions may have to reflect that. This means that DNO directors will be asked to sign on to a scheme which will not be finalized in all its aspects and is to be piloted for two years. It is therefore important that the scheme is sufficiently transparent so that directors are not reluctant to agree to the scheme in March 2010 with one per cent of revenue immediately exposed from 2012.

We support the proposed weighting and whilst there could be some debate over the precise percentages, we particularly welcome the idea that there should be no downside on the stakeholder engagement element given its potential subjectivity.

11.6 Questions

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

Our response is contained in sections 11.1 to 11.4

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

Our response is contained in section 11.5

12 Telephony Incentive Scheme

12.1 Proposed Amendments

We support the proposed streamlining of the attributes which will focus the scheme more clearly and improve the scheme. We have also supported the proposed weighting and the eventual inclusion of messaged customers in the broad measure. Our only concern which may require some consideration by all parties is the scope for much further improvement. The figures show that the number of unsuccessful calls has been gradually reducing during the last four years to the extent that seven companies have below 5% of unsuccessful calls. Your own figure 12.1 shows that WPD would be the only company to be rewarded under the revised scheme and they would only just meet the revised upper bound figure. The proposed lower and upper bound figures need to be carefully considered before the final proposals.

12.2 Questions

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

Our response is contained in section 12.1

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

Our response is contained in section 12.1

13 Worst Served Customers

13.1 Overview

We are supportive of the introduction of a scheme to facilitate investment to improve the quality of supply afforded to worst served customers but are concerned that the proposals will not allow us to do so. Whilst we remain concerned about the overall size of the scheme to improve service for the worst served customers and its ability to reach down to the very worst served, we are particularly concerned about the investment risks introduced as a result of the post investment efficiency and efficacy tests that have been proposed. It remains our view that these tests ought to be removed and replaced with a high level assessment of overall performance and confirmation of investment eligibility.

The IIS has been very successful at improving average performance of our networks; however, owing to the way IIS works it is not always viable to invest to improve the performance of networks with relatively few connected customers - which is typically where the worst served customers are. Given this, we were very encouraged by Ofgem's proposals to introduce a scheme which allowed us to invest in these areas. The proposals for this scheme as set out remain broadly similar to those of the May paper and as such our view and concerns are largely unchanged. The proposal to test the efficiency and efficacy of any investment before allowing recovery of costs introduces unacceptable investment risks that are likely to result in a limited number of investment options. It is our view that these issues are of such significance that if they are not resolved suitably we will struggle to invest even a small proportion of the available funds. We would encourage Ofgem to remove the post investment tests and allow the DNOs the ability to invest appropriately subject to eligibility as per the definitions and appropriate review of investment effectiveness via a general assessment of overall network performance.

13.2 Questions

Question1: Do you agree with the proposed mechanism (in full) for worst served customers?

ENW Response: We do not agree fully with the mechanism as outlined in the Initial Proposals. We agree that as a sensible first step, setting allowances that enable DNOs to target investment to improve the performance to worst served customers is an appropriate response to the issues highlighted although remain concerned about the overall size. We agree that the definition of a worst served customer as outlined is probably about right but that it ought to be reviewed periodically as more experienced is gained. We also agree that it is important to ensure that any investment results in an improvement in the underlying performance of the relevant networks but do not agree that the 25% improvement hurdle is appropriate. We are unable to agree with the application of a cap per benefiting customer. Whilst we understand Ofgem's logic for this we feel that the cap together with the logging up approach introduces significant investment risks that have the potential to severely limit the number of potential investment projects.

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

We do not agree with the cost cap. As we stated in our response to Ofgem's earlier policy paper, it is our view that there should be no post investment test apart from that of eligibility. It is our view that the application of a cost cap at the level proposed (ie £1000 per benefiting customer) would restrict the number of investment options which together with the 25% performance threshold introduces a high degree of investment risk.

14 Interruptions Incentive Scheme (IIS)

14.1 Overview

Given Ofgem are proposing a significant cut in our funding it is hard to see how we can be expected to continue to deliver the good levels of customer service enjoyed by customers in previous years if the cost allowances do not significantly alter from the current position. The funding reductions will require us to reassess the service provisions across all our activities and our ability to respond to supply interruptions will be materially affected. The draft targets have been determined using an approach similar to that used in DPCR4; a key assumption of which is that at the very least current performance levels ought to be maintained and forward targets are set to reflect this. Clearly, fault rates will also be affected by any reduction in capex investment particularly in asset replacement, and as such the methodology for establishing unplanned CI targets must be reassessed. Paradoxically the targets for CML require us to improve on our current performance levels whilst at the same time Ofgem have cut our funding provision. Clearly we cannot accept such a challenge with any expectation of a successful outcome.

Notwithstanding the issue of increasing fault volumes and worsening performance, we would advise that Ofgem take this opportunity to revise the methodology for setting interruption targets. The target setting inappropriately penalises DNOs for good performance in previous years increasing the risk of penalty payments. In addition the current IIS framework restricts the available investment returns for investment based improvements in CIs owing to the timing effects of bounded IIS returns resulting from Ofgem's approach to locking in performance improvements.

We are very concerned that the allowances for pre-arranged interruptions are not sufficient to enable us to complete the work that we have planned for DPCR5. Ofgem are proposing to reduce our submitted forecast for pre-arranged allowances by 36% whilst at the same time expecting us to deliver an increase in volumes of work of a similar percentage. The rationale used by Ofgem to justify this is flawed and we would ask that these allowances be reviewed ahead of the final proposals.

Examination of the IIS as outlined in the initial proposals indicates that the balance of risk is now very much on the down side. The narrowing of the band about the target as a result of an increase in the incentive together with the proposal to roll-forward performance year on year have resulted in a scheme which represents significant downside risk to our business. This approach seems to be deliberately targeted to force as many DNOs as possible into the penalty zone. This approach to incentive manipulation appears to be becoming a consistent theme across the Initial Proposals.

We remain of the opinion that the IIS risks associated with the loss of supply at 132kV and EHV are disproportionate and thus lead to costly and possibly inappropriate mitigation. This is a particular issue during the replacement or reinforcement of substation assets which require long duration outages and thus result in reduced network security, often without any short term restoration capability. We have discussed this issue with Ofgem on previous occasions and we would propose that a

separate scheme be established for 132kV and EHV combined. The inclusion of 132kV and EHV performance within the overall target setting scheme masks underlying performance trends and results in a high degree of year on year performance variability. We set out our proposals in more detail below.

14.2 Unplanned Interruptions Targets

The proposals for setting unplanned targets in DPCR5 remain broadly similar to those of the May consultation paper. As such our views and concerns remain the same and are summarised below. However, one significant change between now and then is the context within which the performance targets are expected to be delivered. When we set out our views in response to Ofgem's May paper, we did so based upon a reasonable expectation that we would be able to fund all our functions from our allowances. The allowances presented in the initial proposals are however very much less than our previous assumed levels and clearly this will affect our views on what an achievable performance level is.

The proposed targets for CI and CML are extremely challenging and are completely disconnected with Ofgem's proposal for significant reductions in funding provision. We are not able to agree to unfunded CML improvement targets whilst at the same time reducing funding in those areas which directly affect performance outcomes.

Once the appropriate target performance levels have been established which reflect appropriately our funding provisions, we feel that it is very important that Ofgem adopt the correct approach to IIS overall such as to facilitate continued investment enabling DNOs to formulate an appropriate business case for investment. The current IIS framework restricts the available investment returns owing to the timing effects of bounded IIS returns resulting from Ofgem's approach to locking in performance improvements. Investments in year 1 of a price review have a full 4 to 5 years to make a return as opposed to investments in years 2 to 4. Investments in year 5 actually have 6 years as performance in year 5 does not form part of the target setting. These effects result from the way Ofgem reset targets at the start of a price review based largely upon the first 4 years of performance in the previous period thus locking in any improvements made and returning all future benefits to customers. This can best be illustrated using the chart below.

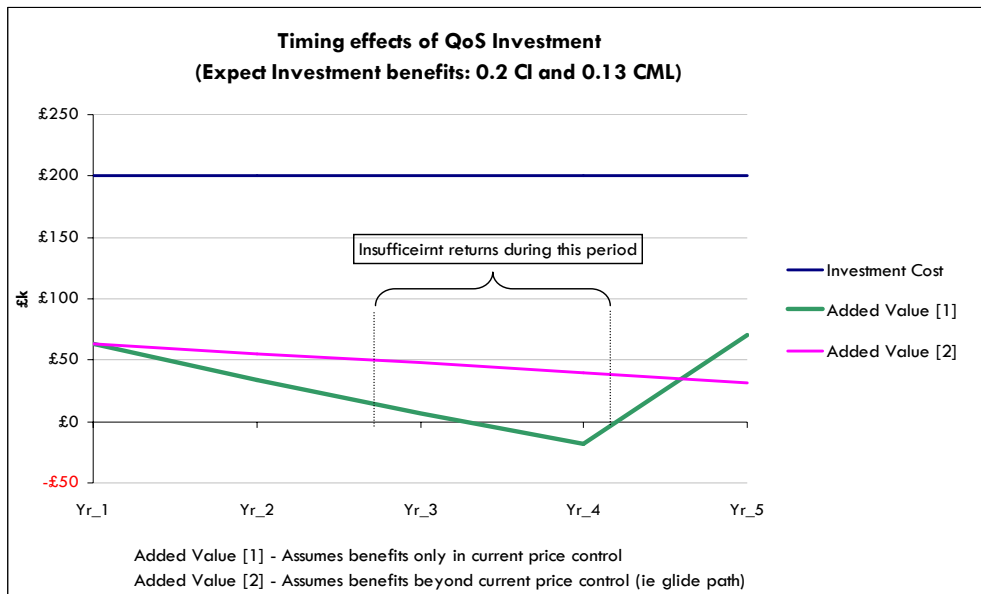


Figure 1 - Chart showing the potential Added Value associated with a typical investment dependent upon the year of the investment (years 1 to 5) using both the current approach and the approach as proposed by ENW

As can be seen from the illustration figure 1, typically QoS project are no longer economically viable after the third year of the price review period. At this point the fact that Ofgem will move to lock-in all future benefits beyond year 5, means that the project does not have sufficient time to recover the capital outlay. As such DNOs have two options; either to defer the investment until the end of the current price review or the start of the next and then to invest in the first three years of that period or, to invest and to take a risk not all the benefits associated with the investment will be reflected in future targets thus ensuring that some benefits remain. It is our view that immediate move to lock in performance and thus apply a step change ought to be replaced with a gradual locking in with a glide path approach (as illustrated in figure 2) such that both shareholders and customers benefit for a period after the investment to a point where only customers benefit.

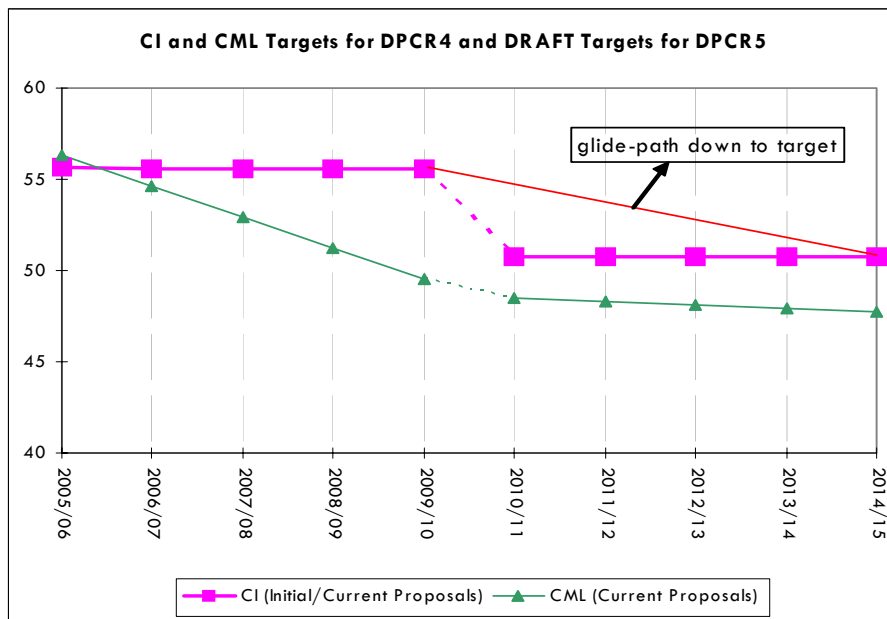


Figure 2 - ENW propose a glide-path approach to replace the current step-change or CI ratchet thus ensuring future CI benefit for shareholders

14.3 Pre-arranged Interruptions Targets

We remain broadly in agreement with the philosophy to continue to encourage DNOs to reduce the number and duration of pre-arranged interruptions by including them within overall targets. However we are unsure of the accuracy of the specific allowances that have been set in the initial proposals. A comparison of our allowance with that of the other DNOs shows that outside London we will have the lowest overall volume. This does not seem consistent with our plans for asset replacement and other activities for DPCR5 which in our view will result in a significantly higher volume of pre-arranged interruptions and not, as currently indicated by the Ofgem view, less. Ofgem have indicated that an approach consistent with that used as part of the recent ESQCR re-opener has been used to establish these values as well as data submitted by DNOs as part of the June FB PQ. We would therefore request that this analysis be shared fully amongst all DNOs with more detailed guidance on how the final allowances have been arrived at.

Based on our analysis you are proposing to cut back our forecast of pre-arranged interruptions by 36% based on your assessment of the allowed expenditure in DPCR5. We are very concerned about the approach that has been adopted here as reductions in allowed investments are based on unit cost reductions and not volume reductions and as such it is not reasonable to reduce our forecast for pre-arranged on this basis. It is also completely flawed to account for any reduction in allowances at 132kV and EHV as activities at these voltage levels have no effect on the forecast volume for pre-arranged interruptions. Further analysis shows that you are allowing a 13% increase in the volume of pre-arranged interruptions in DPCR5 when compared to DPCR4; however this does not align at all with our forecast in increase activities in those areas

which drive the number of pre-arranged interruptions. This analysis shows an increase in volumes of 38% for non-load and 50% for tree cutting in DPCR5 when compared with DPCR4. We are thus very concerned that our provision of pre-arranged interruption allowances as presented in the initial proposals is not sufficient to enable us to complete the volume of work we have planned in DPCR5.

We note that recent changes to DNOs' internal reporting of pre-arranged interruptions should ensure that future reporting is more closely aligned to the Ofgem FBPQ submission. We would also recommend additional changes are made to facilitate reporting of the number of planned interruptions avoided through the use of techniques such as generators which would then allow for a comparison between DNOs of the overall approach to this issue. Despite the changes proposed in the initial proposals we are unconvinced that they do anything to address the specific issues that you have raised previously, ie that a number of DNOs have significantly outperformed on their allowance and have thus received financial gain and an apparent performance advantage when compared to other DNOs. Whilst you have indicated your wish to introduce a flexible approach to the scheme such that a 'pre-arranged pot' is set aside and DNOs are penalised for exceeding this allowance (on a cumulative basis) and only rewarded after assessment of all years' data based upon your methodology, this still appears reliant on any initial assessment of the size of the pot and further fails to account for a situation where a DNO performs more activity than this initial assessment would have suggested. There are clearly areas of genuine uncertainty and potential inequity which need to be resolved and we ask that Ofgem engage further with the DNOs to address this specific issue.

With respect to the specific mechanics of the pre-arranged pot; it is our view that pre-arranged allowances should continue as per the approach in DPCR4. An annual allowance should be set and then added to the unplanned target with DNOs rewarded or penalised on an annual basis.

14.4 Revenue Exposure

Whilst we are generally supportive of the proposals to maintain the revenue exposed to IIS at 3% and thus maintain a strong incentive to improve, we are likely to reject these proposals in the context of an unbalanced IIS. We note the proposal to modify the percentage split via a reduction from 1.2% to 0.8% for CI performance and an increase from 1.8% to 2.2% for CML performance thus reducing the amount of money exposed to interruption performance and increasing the amount exposed to interruption duration performance. We have attempted to illustrate these changes in figures 3 and 4 below.

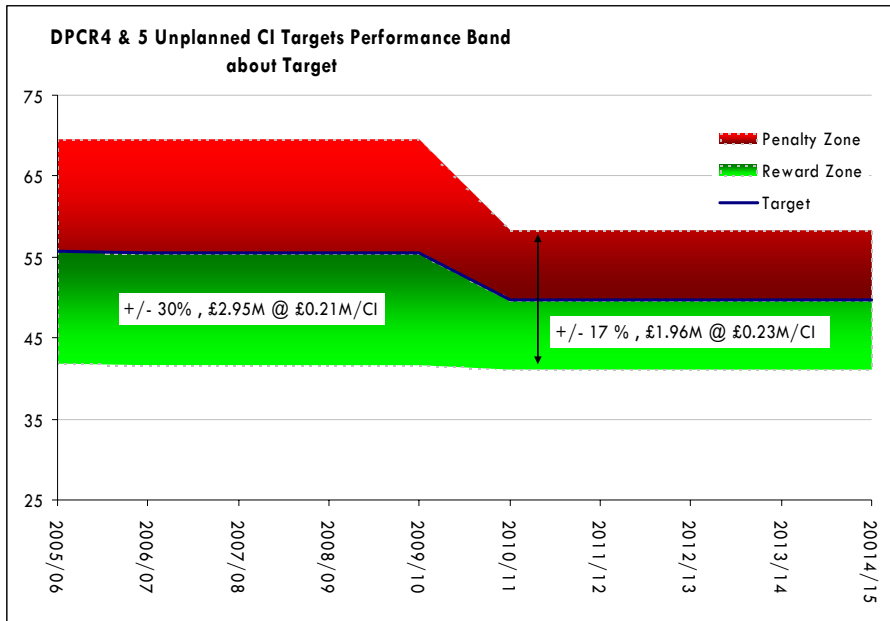


Figure 3 - Chart showing the 'tightening' of the cap/collar band about the CI target in DPCR5 as compared to DPCR4 owing to proposed changes to IIS presented in the initial proposals

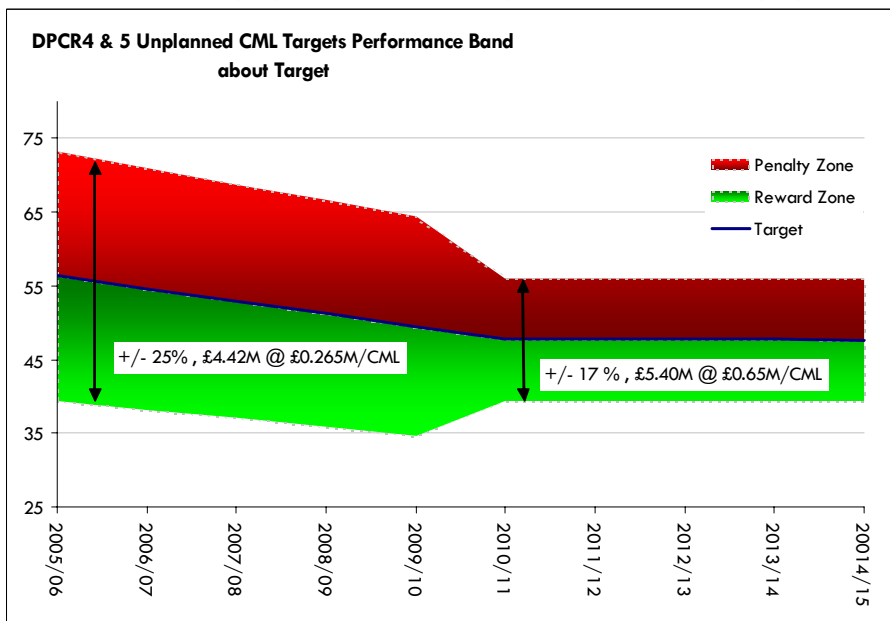


Figure 4 - Chart showing the 'tightening' of the cap/collar band about the CML target in DPCR5 as compared to DPCR4 owing to proposed changes to IIS presented in the initial proposals

It can be seen that the bands about the targets in DPCR5 will be significantly narrower than those of DPCR4. Whilst the overall revenue exposed to the scheme is the same in both DPCR4 and DPCR5 (ie 3%), the changes to the incentive rates have the effect that any slight variations about target will result in large swings in revenue year on year.

Ofgem are also proposing that these caps will apply to the entire DPCR5 revenue ie performance in individual years may exceed the caps and this will be rolled over into an evaluation of performance over the entire period once all of the DPCR5 data is available, with a final "true-up" undertaken in DPCR6. We feel strongly that this change from the current position will increase significantly the overall IIS risk and further adds complexity to the modelling of investment performance. We have already expressed our views in previous responses that the IIS scheme is no longer symmetrical when viewed from a risk perspective and this only adds to that view. The current symmetry of performance bands around the targets represents a significant downside risk. It is easy to foresee a set of circumstances which cause the penalty cap to be hit for both CI and CML in any one particular year, particularly when one considers the consequences of EHV or 132kV events (albeit these effects could be constrained if separate caps are introduced as per our proposal below). It is much less obvious, given that targets are largely based on historic performance, to see circumstances in which the cap on IIS rewards would be achieved. The narrowing of the band and the proposal to roll forward year on year only increases the feeling that the IIS scheme now represents significant downside risk for DNOs.

14.5 Incentive Rates

In our response to Ofgem's May consultation we expressed our concern regarding what appeared at the time to be a significant weakening of the incentive rate for IIS. It was suggested at the time that this weakening better reflected customers' willingness to pay for improvements in network performance. It therefore came as some surprise to see that the incentive rates in the initial proposals had changed quite markedly from those in May with a strengthening when compared to existing rates. We recognise that Ofgem have now updated their willingness to pay research to account for the willingness to pay of business customers and that this together with the domestic willingness to pay is responsible for the increases that have been published. Whilst not in principle an unwelcome change when considered in the context of a balanced IIS, and certainly preferable to the lower rates proposed in May, we are concerned that the rates have been derived from inaccurate estimates of average bill sizes and our assessment of the associated model appear to confirm this.

Whilst any potential errors in the model clearly need to be addressed, our position on the incentive rate remains the same as that of our response to the May consultation. Any move to weaken the incentive should be avoided as it will significantly reduce our ability to invest in the network to improve performance. We may have to adopt a different position to protect our shareholders if the proposed allowances are retained. ENW has always supported strong incentive mechanisms but in this instance, believe that the inadequate allowances are encouraging us to behave in a manner which reduces our risk exposure. Whilst IIS has resulted in improved average performance there remain parts of the network where customers experience unacceptable reliability when compared to say urban districts and it is important that a mechanism exists that facilitates investment in this areas.

14.6 One-off exceptional events

As we have said previously we are supportive of the need to address the issues associated with exceptional events and the sometimes very large financial risks that can arise. Given this we welcome the proposal to widen the type of events that are included within the one-off exceptional event category. It is not clear however if the proposed extension would cover all incidents of any type that occur during periods of construction at either 132kV or 33kV voltage levels where long duration outages are required to facilitate replacement or reinforcement of network assets. It is our view that these periods represent most risk of widespread loss of supply and the current IIS and GS liabilities can on occasion result in costly mitigation, which is often not necessarily in customers' best interests. We would welcome clarification on this point as any fault, of any cause, which occurs at a time of reduce network security owing to necessary long duration outages can give rise to exceptionally high and disproportionate financial penalties. Such incidents would not ordinarily result in any loss of supply, owing to the inherent security standards adopted at these voltage levels; however these standards do not allow investment to reduce future risks during prolonged outages. As we start to increase the number of grid transformer replacement scheme planned for DPCR5 and DPCR6, for example, we are keen to address the issue of excessive risk or risk mitigation.

14.7 ENW proposal for a separate IIS scheme for 132kV and EHV

It is our view that the risks associated with the replacement or reinforcement of assets at EHV and 132kV are both excessive and disproportionate and are not adequately addressed by the Ofgem proposals for one-off exceptional events. The construction activities associated with EHV and 132kV schemes often require long duration network outages usually without any short term restoration availability. During these periods of reduce network security it is not uncommon to move from double circuit to single circuit security whereby several thousand or tens of thousands of customers are exposed to a single equipment failure. Whilst the effects of a failure are dependent upon the exact failure, a worst case scenario would be the electrical failure of a grid transformer. In this scenario a short term repair is very unlikely and it would be necessary to attempt to restore supplies via the emergency restoration of the outaged asset. In the meantime it may be possible to restore some proportion of the supplies via lower voltage networks and further consideration could be given to the application of rota disconnections. In order to reduce this risk it is often desirable to spend money to adopt an approach which enables us to restore more customers in the event of a fault or to even avoid the single circuit risk completely. In some instances, this may be perceived as over-engineering and place higher cost than necessary onto customers. It is easy to see why this is the case by examination of the potential financial penalties that would flow from IIS alone. A typical 132kV to EHV Bulk Supply Point (BSP) will comprise two 132kV to EHV grid transformers which together supply electricity to 30 000 customers or more. If it is necessary to replace these transformers with new ones then there will be a prolonged period when the 30 000 customers are at risk to an equipment failure of the assets that comprise the remaining 132kV to EHV circuit. It may be possible to reduce the number of customers at risk by temporarily transferring a proportion of supplies onto an adjacent BSP. However, it is not uncommon to have 20 000+ customers at risk for a period during this type of activity. Using the incentive

rates that have been proposed by Ofgem in the initial proposals, and assuming that before the fault our forecast performance was that we would meet exactly our performance target, then it would take just 18 hours to hit the CML penalty cap of approximately £6M (ie 0.5 CML or £325k per hour) this is in addition to the immediate £200k CI penalty.

In order to address the issues highlighted above we would recommend the separation of the 132kV and EHV from the existing IIS and the creation a new scheme to cover the combination of these two voltage levels. Targets would be set for performance based on a similar mechanism to that used in DPCR4 but a different incentive rate would be established and a new penalty/reward cap introduced.

We would propose that separate targets be identified for 132kV and EHV combined. The charts below attempt to illustrate how the targets might look as well as indicate the potential range of penalty and reward about the target. Given that this is assessing 132kV and EHV only we would suggest that 10% of the total IIS revenue exposed to IIS (ie 0.3% of revenue overall) is transferred to this scheme and attributed to CI and CML as per the proposals of IIS in the initial proposals (ie 0.8% CI and 2.2% CML). The total money exposed to performance at 132kV and EHV would then be just over £1m per year (£280k and £760k for CI and CML respectively). We would further suggest that the incentive rate be adjusted so as to avoid too narrow a band about the target and we have used 50% of that proposed in the initial proposals (ie £115k for CI and £325k for CML).

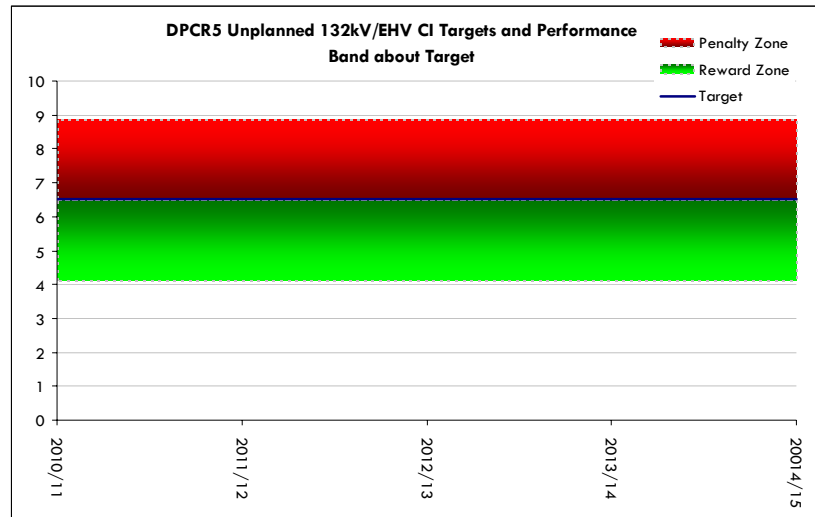


Figure 5 - Proposed CI targets for the separate 132kV/EHV IIS scheme showing cap/collar about target in DPCR5

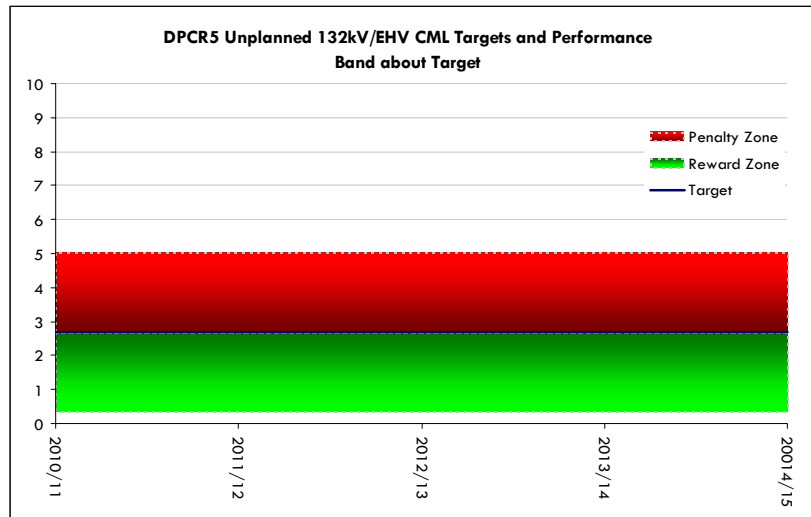


Figure 6 - Proposed CML targets for the separate 132kV/EHV IIS scheme showing cap/collar about target in DPCR5

The targets for CI and CML performance have been identified in exactly the same way as would be used as part of the main IIS. The average performance for 132kV performance is taken together with average performance for EHV and a combined target calculated.

By adopting the approach as outlined above we believe that the current problem of disproportionate IIS risk during long duration outages at 132kV and EHV would be materially reduced and whilst it remains a powerful incentive to minimise the customer effect of interruptions, now allows DNOs to manage risk appropriately during these periods thus avoiding costly pre event mitigation.

14.8 Short Interruptions

We note Ofgem's intention to undertake a further review of short interruptions during DPCR5 and we welcome the decision not to place incentives on this in DPCR5. However, we would encourage Ofgem to complete its review as soon as is practicable. Current investment initiatives aimed at a reduction in the number of customer interruptions can have the side-effect of increasing the number of short duration interruptions. Clearly any future incentive in this area will at the very least influence the design of future solutions and in some instances may even result in schemes not being introduced at all. Care should be taken not to create a scheme which has the undesired effect of removing existing schemes to reduce short interruptions at the expense of an increase in interruptions.

14.9 Questions

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

We agree with Ofgem that there ought to be no further specific allowances for investments to improve the performance of the network but that any investment costs that are incurred fall into RAV. Given this, it is essential that the reward mechanism associated with IIS is designed such that an appropriate financial business case can be developed. Of key importance is the level of the incentive rate. If investment decisions are to be based purely on a sound economic basis, then it is the incentive rate that will determine whether any investment can be accepted. Furthermore, it is our firm belief that the current bounding of returns within the price control period introduces investment risk as we move through the period. Investments in year 1 have a full 4 to 5 years to make a return as opposed to investments in year 5 which have at most 1 year. This is because of the way Ofgem reset targets at the start of a price review based upon performance in the previous period thus locking in any improvements made and returning all future benefits to customers – a situation which unfairly penalises those DNOs that outperform their CI benchmarks. One option that Ofgem could consider would be to replace this CI ratchet with a CI glide path such that both shareholders and customers benefit for a period after the investment to a point where only customers benefit. Another alternative could be the provision a financial reward payable to DNOs for accepting the more stringent target.

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

We are comfortable with the philosophy of the pre-arranged allowance setting. However, we are unsure of the accuracy of allowances that have been set. Whilst DNOs have now amended internal reporting of pre-arranged interruptions to align more closely with the Ofgem FB PQ, the DPCR5 forecasts are still very much based on the DPCR4 approach and as such appear to suffer from the same failings that have been highlighted in previous Ofgem consultations - that being the excessive out performance of allowances by a number of DNOs.

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

We are comfortable with the proposals for overall revenue exposure to the IIS and that this exposure remains the same for all DNOs. With regards to the incentive rate; we welcome the efforts that have been made to derive an incentive rate which is in part aligned to customer value and we note the initial proposals suggests a more powerful incentive in DPCR5. We would stress that any reduction in the incentive for ENW will result in lower overall investment as more projects fail to pass the necessary economic tests.. Whilst we have highlighted separately potential issues of accuracy within the model used by Ofgem to establish the incentive rates we agree that the approach adopted is probably an appropriate first step.

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

We are supportive of the need to address the issues associated with exceptional events. However, it is not clear to us if the proposed extension would cover all incidents (not just those as a result of equipment failure) that occur during periods of construction at 132kV and 33kV voltage levels where long duration outages are required to facilitate replacement or reinforcement of assets. It is our view that these periods represent most risk to loss of supply and the current IIS liabilities can result in costly mitigation that may not be in customers' best interests.

15 Guaranteed Standards of Performance

15.1 Overview

We have no objection to the proposed increase in GS payments to reflect inflation. Clearly it is an anomaly that events that trigger the IIS exceptional events criteria could still lead to a significant number of GS payments often through no fault of the DNO. We agree that either the IIS exceptional event mechanism should reflect that or some sort of payment cap should be introduced particularly where as in some of the recent high profile incidents, no fault attaches to the DNO. The current uncapped exposure to one-off events must be addressed and we would recommend that a cap per customer be introduced similar to that as for severe weather events. However, this needs to be applied in addition to a cap per event if it is going to have any influence on the way we manage risk during large construction projects at 132kV and EHV. This issue is very similar to IIS risk and these issues must be considered in parallel. If Ofgem were to apply a cap per customer of £200 as per the severe weather cap, then following the loss of a Bulk Supply point supplying 30 000 customers for a duration of greater than 18 hours the maximum penalty that would be due is £6m. It is our view that these high financial risks are excessive and are distorting the way in which DNOs approach projects resulting in costly mitigation, ie a transferring of the risk from the DNO to customers. We would recommend that a cap per event of £1m be applied in addition to the £200 per customer cap. This is sufficiently high enough to protect customers against unnecessary risk taking but avoids the problems we have highlighted.

15.2 Questions

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

We have no objection to the proposed increase in GS payments to reflect inflation

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

We agree with this proposal as the current uncapped liability has the potential to drive perverse behaviour.

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

We welcome the proposal to cap the payments in a manner similar to that currently applied to payments during severe storm events. We would also propose that an event specific cap be introduced to ensure that no individual event carries a guaranteed standard risk of greater than £1m.

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

Where rota disconnections are established in response to a wider ESI emergency then it is clearly inappropriate for the DNO to be exposed to GS payments, or even questionable that any customer compensation is appropriate. We would expect the exercising of the powers to impose rota disconnections to be accompanied by the suspension of the GS regimes for interruptions.

16 Customer Service Reward Scheme

16.1 Overview

We agree that the embedding of best practice should not be by way of a new licence condition and we therefore agree with Ofgem's proposal. The scheme should be reviewed as to its usefulness from April 2012. The new broader measure both from the complaints metric and the survey work in particular should reflect the type of initiatives that are currently covered by the scheme and we question the future need for the scheme. If it is to continue after April 2012, it should be more tightly targeted and thus avoid any potential duplication with the broader measure.

16.2 Questions

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

Our response is contained within section 16.1

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

Our response is contained within section 16.1

17 Network Output Measures

17.1 Principles

As noted in our commentary to outputs, we welcome Ofgem's proposal to establish a consistent methodology for output measurement and are committed to working with Ofgem to further develop the framework in DPCR5. We consider that an initial focus on asset replacement and reinforcement is appropriate and that the degree of commonality in presentation between the HI and LI is welcome.

As described elsewhere in our response, we do not consider that asset replacement and reinforcement programmes can be treated as 'ring-fenced' entities, and that, faced with £200M reductions in the IP, the outputs submission made to Ofgem in July would be undeliverable. There will need to be a careful assessment of the linkages between funding and outputs that takes into account programme-level prioritisation. It must be recognised that the outputs regime introduces additional risk to the regulatory framework for DNOs. This risk is acceptable when we receive a sensible allowance level and was in our minds when determining the FB PQ, but the risk is very significant when cost allowances are cut so significantly.

In terms of implementing the methodology, we need to be mindful of unintended outcomes. We need to be sure that the LI methodology and the associated incentives drive the right behaviours in respect of efficient development of the network as opposed to chasing LI targets. We are committed to working with Ofgem to achieve this.

We note that Ofgem characterise the current measures as 'Tier Two' and caution that the current measures are not fully 'aligned with the underlying business processes that are used to plan and operate the network'. In particular, the LI focuses only on one reinforcement driver (ie firm (n-1) capacity) while ignoring the other three reinforcement drivers (P2/6, fault level, voltage limits). A lot of the very small single transformer primaries in the north of our region which are not P2/6 compliant have been installed to address voltage limit issues rather than thermal capacity issues thus their reinforcement justification in terms of the LI measures will not be possible. Since P2/6 compliance is a licence condition it ought to be factored into the LI.

For Health Indices, we are increasingly building consequence and criticality factors into our investment prioritisation to the effect that we are investing for optimum overall risk reduction, rather than simply condition (& hence probability) aspects. A shortfall against previously planned HI targets due to a better overall risk solution being adopted should not be penalised.

To this end we are fully supportive of the proposals to move towards a Tier One holistic measure of network risk in the DPCR5 period, and consider that assessments against the current interim measures should be used in an advisory rather than deterministic fashion. In our response to the cost allowances section of the Initial Proposals, we have repeatedly noted our concern that many of the activities which we

would like to undertake will be constrained or eliminated by the proposed cost allowance projections.

17.2 Mechanism details

We agree with the general principle surrounding the LI framework; however we strongly believe that the LI should be applied to all demand groups (not just substations/sites) to facilitate a complete Tier Two measure that is a proxy to total network risk.

We think that there needs to be flexibility of this methodology and its application to an incentive mechanism over the DPCR5 period to allow for changes in our common understanding and improvements over the period. We are committed to working with Ofgem in this area.

We believe that DNOs should be required report on all relevant demand groups to allow total network risk to be tracked and facilitate early identification of problematic demand groups. This would also provide a complete base position to reference movement in risk profile against.

Over time, we think that there is scope to develop a greater definition of the LI variables (inc. firm capacity, demand transfer, is DG negative demand etc) and measures across the DNOs to ensure that we are all working to a common framework. There needs to be greater certainty of the consequences of under-performance or out-performance of the LI targets and allowed revenue. The LI outputs are highly dependent upon the accuracy of the demand forecast for all demand groups across the network. Changes in demand have never before been so uncertain due to the impact of energy efficiency, DG, economic climate, and unknown future demand on the network (ie electric vehicles, increased heating requirement...). The incentive mechanism associated with the LI outputs has to be:

- Responsive to changes in demand across the network, and;
- Provide sufficient certainty that investment will be allowed (G&P LRE projects have a typical lead time of two years; more if significant consents are required. We need confidence that expenditure will be allowed based on demand forecast otherwise we are incentivised to take a low investment risk that delivers a high network risk).

17.3 Questions

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

Our response is contained within sections 17.1 and 17.2

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

We note that Ofgem have taken on board the concerns raised in response to the May document that outputs are currently in an immature state of development and that their inappropriate deployment may both stifle innovation and restrict a DNO's ability to react to changing information and circumstances in DPCR5. As such their role should be in facilitating an informed discussion of investment patterns and outcomes in DPCR5 between Ofgem and the DNOs. In reaching a conclusion as to a DNO's performance against its agreed outputs, Ofgem will effectively need to normalise for all the factors set out in the chapter (eg changing circumstances, evolving methodologies, new data etc.) through a process of constructive dialogue. We are pleased to note that the tone of the Proposals aligns with this approach; however we will need to collaboratively work on defining an appropriate reporting framework to facilitate the discussion.

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?

We are confident that there should be little need to introduce financial sanctions if the process outlined above is followed and a DNO has responded appropriately to the emerging needs of and information about its network. The document sets out a range of theoretical sanctions that could be deployed as a last resort. In terms of the different options, we consider that, in the majority of cases, the issue will be one of timing of investment given the uncertainties of failure prediction techniques and the long lead times required on many of the major asset types. That being the case, it would appear appropriate to wrap the DPCR5 outputs performance into a consideration of DPCR6 allowances and incentives, whether by amended allowances to accommodate outputs ostensibly already funded, or adjusting the incentive properties of the DPCR6 IQI incentive (or equivalent).

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

This should be incorporated in the overall assessment. In principle, and following normalisation for all relevant factors, a DNO failing outputs with a significant underspend could be accused of negligent behaviour whilst one that fails outputs whilst spending its allowance or overspending could be considered profligate or wasteful. Both have detrimental customer effects and it would seem invidious at this stage to distinguish between the two mechanistically. More important would be the scale of the underperformance against agreed outputs normalised for other factors, irrespective of the level of investment actually incurred.

18 Innovation Funding Incentive (IFI)

18.1 Overview

We agree with the proposal to retain IFI in its current form and believe the IFI funding mechanism has been successful in stimulating R&D in distribution networks. We believe clarity is required in the definition of 'technical R&D' and as stated in the response to the Low Carbon Networks Fund, clear guidance is required on the differentiation between IFI and LCN Tier 1 funded projects. IFI will soon deliver a number of innovations that will require wide scale demonstration trials and clarity is required regarding how these projects should be funded. It is clear that a number of IFI projects over the last five years will now require substantial further investment in order to achieve the significant level of penetration into the network required to deliver high rewards for customers.

Without the investment required for network implementation, the legacy of IFI will be a collection of "good ideas", and customers will not reap the benefits of the innovative R&D that has already taken place.

18.2 Questions

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

Our response is contained within section 18.1

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?

Our response is contained within section 18.1

19 Equalising Incentives and the Information Quality Incentive

19.1 Equalising Incentives

We believe that the move toward equal incentives for operating costs and capital expenditure will allow flexibility in a DNO's solutions to maintain standards of service and investment. We believe that the reduced policing of DNO reported expenditure is a secondary benefit as the reporting regime had matured over DPCR4.

Ofgem has identified a number of benefits of equalisation of incentives. Ofgem has correctly identified that the opex allowance overspends will be partially funded by customers. It is entirely appropriate to provide some protection to shareholders as the allowances as they currently stand, are insufficient but Ofgem needs to consider that partial consumer exposure does not completely alleviate the impact on DNOs financeability of inadequate allowances.

19.2 IQI

Two of the issues associated with the DPCR5 IQI are the perceived risk aversion of management and appropriate level of incentive rate strength. We suggest that these issues are inversely linked. Ofgem has not dealt with the risk aversion issue in DPCR5 but has modified the strength of the mechanism throughout. Sadly, the DNOs have been unable to appropriately respond to the incentive signals as the policy decisions were largely finalised after the bidding process was completed. It is difficult to understand which mechanism the DNOs were responding to when generating the bids (ie DPCR4 or GDPCR). Increasing the strength of the mechanism at this point of the bid process does not allow the DNO with the opportunity to respond. What the proposal does achieve is adding additional risk to the price control process which will have to be compensated via a different route.

We have a specific concern with the proposed modification of the start to earn points in the matrix. We believe that the incentive properties of the mechanism have diminished throughout the price control process due to delays in publication and by the proposal to modify the strength of the incentive after the "bidding" process has completed. We suggest that the start to earn points should not be made tougher as the IQI mechanism (supported by agreed outputs) is one of the most tightly controlled aspects of the price control and the additional tightening would appear to be unnecessary.

We believe that IT, property and network policy costs should be included within the IQI mechanism. This recognises the trade-offs in company decision making between these activities and other activities within the IQI.

19.3 Questions

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

Our response is contained within section 19.1

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?

Our response is contained within section 19.2

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

Our response is contained within section 19.2