

Rachel Fletcher
Director, Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Paul Whittaker
UK Director of Regulation

paul.whittaker@uk.ngrid.com
Direct tel +44 (0)1926 653190
Direct fax +44 (0)1926 656520
Mobile +44 (0)7776 170735

www.nationalgrid.com

14 September 2009

Dear Rachel,

DPCR5 – Initial Proposals

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as Great Britain System Operator (GBSO), we operate the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain and, through our gas distribution business, we distribute gas in the heart of England to approximately 11 million offices, schools and homes.

Through our subsidiaries, National Grid also owns and maintains around 20 million domestic and commercial meters, the electricity Interconnector between England and France, and a liquid natural gas importation terminal at the Isle of Grain.

Our response to this suite of consultation documents is in two parts: this covering letter provides a brief overview; an appendix picks up detailed comments from each of the documents. The response is not confidential.

Overall we were impressed with the detailed, comprehensive and transparent consultation material. We have three areas of concern:

- The complexity of the emerging regime
- The unconvincing cost analysis, and
- The incomplete nature of the initial proposals.

Complexity

DPCR5 is a logical extension of the approach which Ofgem (and its antecedents) have followed for the last twenty years. It is founded a series of beliefs: that networks will respond predictably to incentives and, given this, that price controls with ever more careful definition of the required behaviours, accompanied by ever more specific incentives, will deliver improved performance.

In principle, it is difficult to argue that this is an unreasonable approach. However, there is always the risk that the range of incentives being created:

- confuses or obscures the fundamental roles which networks should be seeking to fulfil, and/or
- singly, or in combination, could, under certain circumstances, create perverse or conflicting incentives.

These risks are likely to be most acute in times of uncertainty and rapid change – arguably conditions which are likely to apply in the coming price control period.

Cost analysis

On a similar theme we note that Ofgem have extended the range and sophistication of their cost assessment techniques since we last engaged with them during GDPCR. Despite the increasing level of sophistication we believe that there are two major problems at the heart of the analysis.

1. Ofgem have not unambiguously demonstrated that the cost differences which they have identified are the result of efficiency differences rather than the result of inconsistent cost allocation approaches between networks and/or the result of choosing imperfect cost drivers. The level of efficiency variation apparently identified seems surprising following 20 years of successful RPI-X incentive regulation.
2. Ofgem have set network capex and opex allowances separately but they then combine them within a single incentive scheme. Even in principle, this approach cannot identify the most efficient approach to minimising the long-term costs of building, maintaining and operating networks. In practice, any incentive benefits created by equalising the treatment of costs which arise within period are compromised by uncertainty about how enduring operating costs will be benchmarked at the next review.

Incomplete Initial Proposals

We were disappointed that DNO's have been provided with little guidance on two of the key components of the price control settlement:

1. The allowed return – with only a vanilla return range of 210 basis points to act as guidance; and
2. The allowed pension's costs.

This seems an unprecedented level of financial uncertainty so late in the process.

Should you or your colleagues require further information on this response please do not hesitate to contact me.

Yours sincerely

By e mail

Paul Whittaker
UK Director of Regulation

Electricity Price Control Review - Initial Proposals (92/09)

CHAPTER 3

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

Ofgem's initial proposals have been set after coming to a view on the efficient levels of network investment, operating costs and indirect costs but with only working assumptions on the cost of capital (5.55% vanilla) and cost of pensions (as per DPCR4). The overall allowed revenues and the results of any financeability assessment will be very sensitive to final views on these parameters. The notable absence of a view on these factors significantly reduces the value of the initial proposals as an indication of future revenues and as an indication of future financeability.

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

It is appropriate (and in the interests of regulatory consistency and stability which benefits consumers) that Ofgem should take an approach which is weighted to towards long-term indicators and is consistent with the approach in previous settlements.

Short-term factors should be taken into account where these affect the financeability of a network, and/or should Ofgem decide to introduce automatic re-openers on WACC

We note that PwC have identified a very wide range for the WACC – we are disappointed that Ofgem have failed to identify a narrower range at this stage in the review process.

A WACC towards the high end of this range would be more appropriate than a lower figure as it would:

- reflect increasing investment levels and the need to finance these;
- reflect the impact of recent capital market developments on the long-term cost of capital (especially cost of equity)

Given the turbulence in financial markets, we do not believe that Ofgem should use higher levels of gearing in setting the WACC.

Question 4 - What are your views on the debt trigger mechanism?

We welcome Ofgem's commitment to ensure that efficient operators can finance their operations and we understand Ofgem's concern with introducing a new mechanism.

In relatively stable market conditions, we agree that interest rate risk is better managed by companies than by consumers/customers (so long as networks are compensated for bearing that risk).

As long as Ofgem set realistic estimates of DNO costs and a realistic WACC based on a long-term sustainable view, efficient DNOs should normally be able to finance their business. The existing disapplication mechanism is available, appropriate and sufficient to deal with a situation where one or more companies faced financial distress as a result of developments in capital markets that are beyond their control.

However, providing greater clarity as to how the existing disapplication might work could give some additional transparency without creating any conflicts or inconsistency with the wider regulatory approach.

We note that Ofgem has undertaken work to assess financeability indicators and will presumably update this for Final Proposals. If this analysis shows that efficient networks may have difficulty financing their activities under likely scenarios, and where WACC has been set on the basis of long-term indicators, it indicates that either baseline estimates have been set too aggressively or incentive mechanisms have been set incorrectly (giving very strong incentives at the cost of increased risk of materially adverse cash flows and returns) rather than suggesting that a new re-opener mechanism is needed.

DPCR5 Initial Proposals - Appendix

Were Ofgem minded to introduce a new mechanism for dealing with uncertainty, we would agree with PwC that Option 4, “Introduce a Substantial Effect Clause”, would be the most practical approach and would be one which is more consistent with the overall price control framework than introducing a specific cost of debt trigger mechanism or specific cost of debt re-opener.

CHAPTER 4

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

We agree that

- it is appropriate to take a holistic view of all elements of the price control settlement to ensure that they provide a fair balance of risk and reward
- the highest performing DNOs should earn the highest return
- where possible, incentives should encourage improvements in performance and should be rewarded appropriately
- DNO financeability tests are important in assessing the sustainability of the settlement.

We would not agree:

- with the suggestion that, if Ofgem revise their view of DNO costs and increase the level of baseline expenditure, incentives mechanisms should be recalibrated
- that the level of price increases customers can be expected to bear should be an important determinant of the overall settlement: such concerns are obviously an important and legitimate influence on the level of price increases in the DPCR5 period but such concerns would be more appropriately addressed through the phasing of cost recovery (balance of slow vs fast money) rather than by tilting the settlement against the DNOs or suppressing incentives mechanisms which have been introduced to encourage DNOs to deliver outputs that customers want.

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

This question appears to conflate two different questions. The first is what is the right WACC for a DNO? – it conceptually covers the systematic risks inherent in owning and operating a DNO. The second is what adjustments need to be made to the WACC to allow for any asymmetric risks and uncertainties inherent in the price control settlement and the possibility that some of those risks and uncertainties (even if symmetric) might be realised in an adverse way simultaneously?

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

Incentives should be used to encourage companies to deliver outputs and above average performance, so the mechanism needs to be strong enough to achieve this. Where consumers benefit from the improved performance, the incentive should be calibrated such that any increase in costs for consumers under the mechanism matches the value consumers place on the higher performance. Where benefits are seen by different stakeholders (e.g. government as well as consumers), such as environment-related incentives, the mechanism should be calibrated such that additional revenue that can be earned by a DNO is matched to the aggregate benefit ascribed to the improved performance by these different parties.

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

We note Ofgem's intention to develop their modelling of uncertainty, and the recognition that Ofgem need to ensure that licensees are able to finance their activities. If any event not covered by a specific mechanism threatened a DNO's ability to finance its activities Ofgem would need to give serious consideration to reopening the price control.

**Electricity Distribution Price Control Review Initial Proposals
Incentives and Obligations (93/09)**

CHAPTER 1 – Low Carbon Networks Fund

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

National Grid agrees with Ofgem's proposals for a new Low Carbon Networks Fund (LCN), and proposes that similar mechanisms should be developed in respect of transmission and gas distribution in future reviews. We have noted elsewhere that a gap is opening up ahead as we seek to satisfy the intensifying demand for new technology to facilitate a low carbon energy infrastructure. Of particular importance will be the likely need to sponsor large scale demonstrator projects to prove new technology (for example Smart Grids, biogas and smart metering) will work on real networks. To demonstrate the benefit of these longer term projects may be challenging in pure financial terms, and a LCN for other networks would make an important contribution.

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?**

The proposed size of the funding is strongly supported although we note that some major capex trials still may not be covered by this level of funding.

Care will be needed in the management of the projects to ensure they are appropriately managed and do not end up being managed in dual processes within Ofgem and the DNOs. It is recognised that the management of innovation is critical and different from the more proven capital or revenue projects, in particular we welcome Ofgem's recognition that a nil or negative conclusion may also be a success in R&D terms

There are likely to be beneficial projects which cross transmission/distribution boundaries – especially as we work towards developing a Smart Grids. Workable mechanisms will be needed to ensure the benefits of such joint projects can be realised.

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

This is a difficult balance to strike – customers are contributing significant funds and the value of the schemes may only become clear with hindsight.

Given that 3rd parties may be involved in the projects, the proposals to share intellectual property (IP) across the GB network licensees may not be workable. The contractual implications of these proposals need to be considered further as this may threaten the success of the LCN funding and ultimately work to the detriment of customers. IP issues have sometimes become an issue in working with the Energy Technology Institute and it would be unfortunate for this scheme to fail to reach its full potential because of IP issues.

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?

To enhance incentives, DNOs should be allowed to use any benefits accrued from the project to cover their contribution to the project funding.

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?

The experience of IFI is that the ramp rate for funding increases significantly after the initial phase. We strongly recommend that a more extreme ramp rate is applied and that roll-over

DPCR5 Initial Proposals - Appendix

funds are allowed to cover unforeseen issues – this is important given the “R&D” nature of these projects.

CHAPTER 2 – Provision of Information to Distributed Generation

National Grid believes that the provision of information in this area is important and, in a similar context, is working on developing the communication regime to support the development of DN-embedded entry facilities, with biogas particularly in mind.

CHAPTER 3 – Distribution Generation Incentive Framework

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

We agree with the proposed incentive framework for the connection of distributed generation, and suggest that a similar incentive should be put in place in the next GDPCR in relation to the connection of renewable gas projects to the gas distribution networks. However, we also believe that it is essential to consider the appropriate balance between societal costs and benefits in determining an appropriate incentive framework. In particular, there may be a strengthening case for providing added encouragement to the development of low net carbon generation, through a level of subsidy for connection costs.

CHAPTER 5 – Transmission Exit Charges Incentive

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

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

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

National Grid broadly supports the hybrid framework proposed for transmission exit charges and we offer the following observations on how it could benefit from further development.

We agree that the incentive will focus the efforts of each DNO to compare the costs of all options when deciding on capacity reinforcement. National Grid holds regular liaison meetings with the DNOs to discuss network requirements at the Grid Supply Point (GSP) interface. The Joint Technical Planning Meeting (JTPM) discusses both GSP reinforcements and asset replacement.

National Grid's Transmission exit charges are annuitised charges set to recover the cost of the connecting assets and include a reasonable rate of return. The majority of GSPs fall into this arrangement. The remainder are those where the connecting assets are classed as infrastructure because National Grid owns the LV busbars. Typically, these GSPs will have two DNOs or a DNO and a power station connected. For the incentive to work as effectively at these sites, the DNO would need to know the equivalent costs of infrastructure reinforcement. Such an arrangement could be a feature of the incentive and could involve National Grid providing a shadow offer to the DNO. Alternatively, these sites could remain outside of the incentive arrangement.

For the DNO to make an effective comparison between reinforcement options, an NPV calculation needs to be performed which predicts National Grid charges going forward and discounts them back to compare with the capital costs of DNO works. It is important that comparisons are made not just on the capital costs of installation but also the maintenance of the assets as these are included in National Grid's exit charges. It should also be noted that if National Grid connection assets fail prematurely or we decide to reconfigure the network and install different types of connection assets, we continue to charge for the old asset until it reaches the end of its charging lifetime (typically 40 years). There is thus some added value to be taken account of in determining these comparisons.

Other factors that may need to be considered in the NPV calculation are any increased costs on the HV system as a result of development on the LV network. For instance, if the incentive

DPCR5 Initial Proposals - Appendix

led to a situation where LV reinforcements are the norm and GSP groups are run very much more interconnected than they are now, it would be necessary to plan outages on the HV system around the DNO network plan which could lead to higher BSIS costs and reduced operational flexibility.

The proposal as it stands relies on the DNO being able to forecast not only demand going forward but also the costs of construction to meet that demand. To avoid windfall gains for an unforeseen recession or shortage of funds for an unforeseen pick up in the economy, revenues would be best pegged to revenue drivers. Such an arrangement could also deal with completely new and unforeseen localised demand and could be adapted to deal with new embedded generation that triggers GSP reinforcement.

It is important that the DNOs are able to look beyond the price control period and make decisions that have longevity and do not result in stranded assets. The proposal as it stands could promote short term decisions with investments just big enough to solve the immediate need. For example, an investment on the DNO network for say an extra 25MW will look better value than a higher investment in connection assets which delivers 200MW capacity. If the first investment lasts only a couple of years and then the second is needed in the following price control, the first assets are effectively stranded.

The proposal tries to make a clear distinction between costs that will be subject to full pass-through and those subject to the sharing factor (Table 5.1). Where some clarity may be required is for the situation where National Grid replaces a time-expired low rating transformer with a higher rating unit. This is both asset replacement and reinforcement occurring at the same time and some splitting of these costs with suitable modifications to the incentive would be necessary for it to work as designed.

CHAPTER 6 – Losses Incentive

We support actions to incentivise for electricity losses as they comprise a significant source of greenhouse gas emissions

We are concerned that any changes in operational arrangements, in the interest of reducing losses, do not adversely impact other transmission system limitations such as fault levels thermal limitations or voltage limits.

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

The proposal relies on loss reductions being estimated accurately; any error in the estimated benefits would lead to windfall gains or losses.

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

We are uncertain as to why the wholesale price of electricity is included within the incentive; the gas distribution incentive is based purely on the Shadow Cost of Carbon. We would agree with a rolling retention mechanism, since it provides a clearer investment opportunity for reducing emissions.

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

Improved measurement does not actually lead to reduction in losses, and therefore there is uncertainty as to whether this can be viewed as a reduction mechanism in itself.

CHAPTER 8 - Business Carbon Footprint Reporting

Question 1 - Do you agree with our (Ofgem's) proposal for BCF (Business Carbon Footprint) reporting requirements?

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

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

National Grid is committed to playing its part in addressing climate change and supports Ofgem's proposals to introduce a reporting mechanism that will encourage DNOs to consider and manage the carbon impact of their operations, and will improve transparency by making available information on the DNOs emissions.

National Grid plc already reports its emissions, in a way that is largely consistent with the mechanisms described in the DPCR5.

A reputational incentive only is appropriate: we don't think that the proposals will have a significant effect on the electricity DNOs in terms of increasing their efforts to reduce carbon emissions, as other mechanisms that are already being introduced (principally the CRC mechanism being introduced in 2010, but also the proposed losses incentive within the DPCR5 proposals) will create financial incentives and are likely to have a stronger effect. However, the requirement to report emissions to Ofgem and the publication of a "league table" will encourage transparency;

Whilst we support the introduction of a league table, we don't feel that this should be based only on reductions in emissions compared to a baseline year (2010-11) (as implied in Ofgem's Paras 8.8 and 8.16), as this can be distorted by a range of factors, e.g. changes in level of activity or the weather from year to year. Whilst we acknowledge Ofgem's comments at Para 8.8 regarding the difficulties of seeking to normalise emissions by different DNOs, we feel that a more complete picture would be obtained by considering (i) absolute levels of emissions (tonne carbon equivalent), (ii) reductions from the baseline year (in %), and (iii) an intensity measure that expresses the carbon emissions per relevant unit/quantity (such as MWh throughput, or number of consumers).

As far as possible a new reporting obligation should not place additional burdens on the companies but should be aligned to existing reporting processes or other reporting requirements that are being created, e.g. through the Carbon Reduction Commitment (CRC)

We feel that where a particular category of emissions has previously been measured by a company and declared to be de-minimis there should be no requirement for a company to re-assess and/or report this category of emissions in future years (unless there has been a change to the company's operations such that the previous assessment is no longer applicable).

CHAPTER 10 – Connections Incentives and Obligations

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

National Grid agrees with the principle of requiring monopoly utilities to operate to within guaranteed standards of service insofar as this provides a degree of protection for customers in the absence of competition. However, an onerous level of performance obligation can be counterproductive and stifle the development of competition. To the extent that competition exists, then guaranteed standards should not apply.

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

There would have to be an objective basis for doing so, i.e., clear evidence that a particular problem or weakness requires resolution.

DPCR5 Initial Proposals - Appendix

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

Penalties should be capped and the underlying principle should be that the maximum level of compensation should be held in proportion to the cost of connection.

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?

National Grid's view is that where guaranteed standards of performance apply, the additional application of performance targets is of questionable value, as this does not necessarily provide meaningful additional protection for customers.

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?

National Grid agrees with the principle that network operators should be able to earn an appropriate level of margin and therefore the principle that underlies Ofgem's market segmentation strategy. Certain segments of the connections market may be inherently more or less open to competition than others and margins should be set to provide a balance between reasonable reward and the facilitation of competition where that is feasible, whilst avoiding abuse of dominant market position.

We would observe that whilst a number of independent connection providers (ICPs) may be available as potential competitors, their ability to compete may be impeded by other legislative factors that prevent them operating on an equal basis to that of a utility company. For example, within the gas market ICPs are not recognised under planning laws or the New Roads and Streets Works Act and whilst these restrictions are in place an ICP may remain unable to compete effectively.

CHAPTER 11 – Broad Measure of Customer Satisfaction

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

We agree in principle that customer experience is more appropriately measured in its broadest sense – capturing the experiences of many types of customers, across all aspects of the services provided by the DNO.

The proposed scope of this measure (customer satisfaction survey results, complaints metrics and stakeholder views) should provide Ofgem and the DNO with a good overall appreciation of customer experience. However, in order to derive useful outputs that will drive improvements in customer performance it is important to ensure that all satisfaction measures are focussed on those service aspects that are most important to customers. It is also important to ensure that customer feedback is sought on a regular and timely basis to enable the DNOs to take action to improve.

Specifically, we are concerned that the inclusion of 'general enquiries' in the scope of the customer satisfaction survey may skew results. Customers of both electricity and gas networks are often confused by industry structures, resulting in significant numbers of misdirected enquiries which cannot be resolved by the Network Owner.

Regarding the inclusion of Complaints metrics in the measurement of overall customer satisfaction, while we agree that such metrics are relevant the detail should be reflective of Standards around complaint handling and of those aspects that are most important to customers, i.e. first time resolution in a timely manner (not necessarily, for example, % of complaints resolved in 1 day).

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

We agree that incentivising good customer service should drive performance improvement but incentives should only be introduced following a pilot and that revenue exposure should

DPCR5 Initial Proposals - Appendix

be limited during this control period. Such an approach will enable Ofgem to ensure that the new measures of customer satisfaction are focussing the efforts of the DNOs in those areas that matter most to customers.

Regarding the proposed weighting of incentives, we are supportive of an approach which offers equal risk and reward for performance but would welcome additional detail as to the mechanism for setting benchmark performance. We are supportive of an approach which takes account of the impact of 'regional factors' on customer satisfaction.

We agree that stakeholder engagement should represent an opportunity to benefit from delivering superior customer focus, but that in order to ensure an appropriate level of focus on end customer satisfaction, performance in this area should not be penalised.

CHAPTER 14 – Interruptions Incentive Scheme (IIS)

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

Assets operated by network businesses are designed to a particular set of standards that reflect the outputs (energy carrying capacity, safety, reliability etc.) demanded from those assets. Consequently the amount of money invested, and the level of maintenance conducted, will similarly reflect the required outputs.

It is likely that existing assets will not be able to deliver increased performance levels without additional investment or enhancements to maintenance regimes, each of which is likely to increase costs.

We feel it is not appropriate for shareholders to fund these costs. If it is felt that increased outputs are required then the costs should be borne to those benefiting from them.

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

The exceptional events mechanism appears to be too subjective. We feel that it should be defined in quantifiable terms when the mechanism would apply.

CHAPTER 15 – Guaranteed Standards of Performance

Question 1 - Do you agree with the proposal to increase failure payment levels to reflect inflation?

We do not believe that the direct indexation of GSOP payments is appropriate; it introduces additional process and a level of accuracy (odd pounds and pence) on a value that has been determined using a general methodology. It should be reset at each review.

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

Payment caps for one off large events are an important feature of the GSOP arrangements to ensure fair treatment for Customers and Network Owners. We are supportive of a review of those types of event that are eligible for review under the IIS one-off exceptional events mechanism to ensure that Network companies are afforded an appropriate level of protection. Any proposal to link payments with the outcome of an IIS claim would need to take account of the impact on customer experience, where customers may be left waiting to find out whether they are entitled to compensation.

A cumulative cap on GSOS exposure would mean that the customer still gets paid, but it is unclear as to whether the cost is recoverable. If the cost is not recoverable, in order to ensure fair treatment of the customers, there must be an event specific cap per customer.

CHAPTER 16 – Customer Service Reward Scheme

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

We agree that minimum standards are generally a more appropriate mechanism for embedding best practice, as opposed to the introduction of new licence conditions which limit flexibility. Given the introduction of the broad measure of satisfaction and new Connections Standards, it is important that Network Owners are given some flexibility in where and when they focus efforts to improve customer service in those specific areas covered by the Reward Scheme.

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

It is important to ensure that individual aspects of customer service are not incentivised through more than one mechanism. If Stakeholder Engagement is covered in the new broad measure it should be removed from the Reward Scheme.

Ofgem must ensure that where rationalisation does occur, the overall level of the incentive is not reduced. Rationalisation may in fact provide an opportunity to increase the level of the incentive.

CHAPTER 17 – Network Output Measures

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

National Grid agrees with the general principle that the measures should be established to capture outcomes such as performance, asset health, network capacity/headroom and network risk.

National Grid also agrees that network output measures should promote continued improvement in asset management. The proposals contained within the document are focussed upon outputs, and not on the approach for obtaining these outputs. National Grid would welcome further proposals that promote innovation in asset management capability.

The proposals document recognises that fault rates exhibit natural year-on-year volatility. However National Grid does not agree with the statement that a five-year rolling average¹ would necessarily take account of this annual variation; as population sizes decrease (as assets are being replaced), the fault rate for the remainder could vary greatly.

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

National Grid agrees that careful consideration of the reasons why output measures have out-turned differently than expected will be required.

Time will tell to what extent the current generation of output measures provide a stable basis for assessing satisfactory performance so, at this stage, it is sensible that they initially provide a basis for discussion and investigation with the companies.

Annual reporting of network output measures will provide Ofgem and companies with a significant opportunity to investigate any apparent trends.

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?

Network output measures should not be treated as hard targets until they have proved stable determinants of network condition and performance. Any decision to impose financial consequences should be taken only when measures are fully-developed, tested and

¹ The decision to choose a time-based average over a weighted average based on population size may also have an impact – the proposal does not make clear the chosen averaging method.

DPCR5 Initial Proposals - Appendix

understood and only then in the light of evidence received from DNO's concerning the reasons for failure.

Once these conditions have been met, it may well be sensible to claw back financial benefits that networks may have gained from the failing to achieve the output measures and to consider penalties. However, all things being equal, the majority of the financial benefit of any underspend (or reduced overspend) will actually have accrued to consumers through the operation of incentive mechanisms. In considering proposals to require networks to catch-up investment Ofgem will need to consider the treatment of the financial benefits that consumers have enjoyed.

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

In principle, the benefits that accrue to companies (and consumers) through avoided investment accrue whether that avoided spend is classed as overspend or underspend.

CHAPTER 18 – Innovation Funding Incentive

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

National Grid fully supports the retention of IFI funding at a level of at least the current levels as this provides the innovative ideas and solution necessary to develop low carbon networks.

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?

Given that National Grid has achieved full spend of the IFI allowance within 2 years of its implementation with a focus on technical R&D, we are supportive of the new proposals for low carbon network funding and would encourage at least maintenance of the current IFI funding.

CHAPTER 19 – Equalising Incentives and IQI

Dealing with all types of expenditure (excluding business support) in a common way (and with equal strength incentive) should help to mitigate some of the potential distortions caused by capex/opex trade-offs.

However, as long as the allowances for capex and opex are calculated independently, significant distortions are likely to remain. For this reason we doubt that the incentive fully achieves the equalisation aim: networks will still need to weigh up the impact of the separate approach to setting opex and capex allowances at the next review and assess whether continuing (efficient) opex will be benchmarked out at the next review so that they would therefore be better off spending (inefficient) capex.

Ofgem's view, in the May consultation document, was that 80% capitalisation would give broadly consistent results compared with continuation of DPCR4. Ofgem has now proposed raising this to 85% in light of the increased network investment for DPCR5. This would seem to suggest that the capitalisation rate would be varied in future depending on network investment levels which we believe to be an appropriate approach although it will be important to ensure that company performance at, or better than, the overall financial package will maintain investment grade credit rating.

We believe it is appropriate to increase the incentive strengths from the current range of 20-40% to 30-50% which would broadly maintain the existing weighted average incentive rate for network-related costs.

Electricity Distribution Price Control Review Initial Proposals Allowed Revenue – Cost Assessment (94/09)

We have limited our comments on this very specific DNO cost document to some general observations.

Cost assessment approach

The approach adopted for DPCR5 represents further developments to benchmarking approach used at GDPCR, e.g. normalisation adjustments for sparsity and urban working and the use of a range of statistical techniques to sense check results.

However, while it is clear from the documents that while Ofgem have greatly extended the range of tests that they apply to data, it is not at all clear that the analysis definitively exposes performance/efficiency differences or merely variations in the construction and reporting of data. The range of performance efficiency apparently revealed is surprising given the success of 20 years of RPI-X incentive regulation.

Ofgem (implicitly) acknowledge this problem in choosing a mixture of upper quartile and average benchmarks for each of their cost control pots; however, we were surprised that Ofgem discarded the top down assessments so readily when aggregated data clearly does not suffer from the same level of reporting “noise”.

Interaction between cost assessments and IQI

Partial funding for large investment schemes where there is uncertainty over the precise timing and cost of such projects is a pragmatic approach. However, it's not clear how the proposed treatment interacts with the IQI mechanism. Recognising the impact of external factors (e.g. planning permission) on major investment schemes it may be appropriate to exclude such schemes from the IQI. Companies may be forced to opt for a weaker incentive for the majority of expenditure so as not to expose shareholders to unnecessary risk if the major scheme should go ahead as expected. For example, if a company believes that it will be necessary to spend significant sums on a particular scheme but Ofgem has only provided an ex-ante allowance for part of the cost (with an ex-post adjustment in the next price control dependent on actual investment), will its shareholders be exposed to a 50% sharing factor if it accepts Ofgem's proposals?

Real price effects

Recent market/economic conditions make it difficult to forecast the scale of real price effects over the coming years.

- The assumption that efficiency offsets real price impacts potentially ignores the specific pressures that can affect the specific costs DNO's face e.g. environmental issues (such as landfill tax), special road surfaces, restricted working hours for road openings (significantly reduced productivity), etc.
- Utility investment programmes are driven by long term network requirements. The negotiation of long term contractual relationships, which are essential to secure the skilled and specialist resources to deliver these investment programmes, can be at odds with the suggestion that short term economic conditions can be used to “negotiate hard”. The long term programmes are generally not impacted by short term fluctuations in the macro economic climate i.e. there can be limited scope for turning work off or on depending on economic climate.

DPCR5 Initial Proposals - Appendix

Electricity Distribution Price Control Review Initial Proposals Allowed Revenues and Financial Issues (95/09)

We only have minor comments beyond those made elsewhere in this response.

CHAPTER 4 – Corporate tax allowances

We agree with the development of a tax trigger and believe the definition of legislative changes should include changes in tax law, changes in accounting standards, changes in case law and changes in HRMC interpretation.

Whether extending such protection leads to a material automatic change to the cost of capital may depend on the extent to which such risks are regarded as systemic or diversifiable.