SP Distribution and SP Manweb (SP Energy Networks)

Response to Electricity Distribution Price Control Review

Initial Proposals August 2009

(Reference 92/09, 93/09, 94/09, 94a/09, 95/09)

APPENDICES

14th September 2009

INDEX

SECTION 2 - MAIN CONSULTATION DOCUMENT 92/09

92/09 Ch2 Q1: Have we introduced a set of measures that can be understood by customers and other stakeholders?

On the package of incentives, we believe that the proposals will increase the complexity of the overall package and in particular that its transposition into detailed Licence Condition modifications will be challenging. It is probable that customers and stakeholders will not be able to understand the detail of what is implemented.

2.1 APPROACH TO SETTING ALLOWED REVENUES

92/09 Ch3 Q1: *Have we taken an appropriate approach to setting allowed revenues?*

Whilst we are encouraged that the proposals recognise the need for substantial investment in the industry to manage the UK's ageing Distribution infrastructure and deliver European and UK energy policy we are disappointed by the significant number of areas that remain outstanding, or are a long way from complete, notably the cost of capital, pensions and operating cost allowances.

From our perspective there are a number of key issues that must be addressed and upon which the success of this price review will rest.

These are detailed in our accompanying executive summary.

2.2 INFLATION / REAL PRICE EFFECTS

92/09 Ch3 Q2: What assumptions do you think we should use for real price effects on DNOs over the 2010 to 2015 period?

Inflation/Real Price Effects: We anticipate that Revenues will be affected by negative deflation in the first year of the price control, however the stark reality is that utilities continue to be adversely impacted by prices for labour, materials and contractors. This will adversely impact companies' ability to finance their activities.

It is unreasonable to expect the DNOs to be able to keep costs at or below inflation in this environment. In particular, we believe that Ofgem has understated the labour cost pressures that DNOs, their contractors and manufacturers will face during the next six years by failing to recognise any differential wage inflation for skilled infrastructure specialists and by assuming that average earnings return to an inexplicably low rate of growth when the recovery from the current period of recession is completed. It is also important to note that CEPA's position on this area, and upon whose work Ofgem relied, appears to have changed dramatically. We would refer Ofgem to their latest report published this month.

The risk companies face in this area will be further compounded by the proposals that they are being asked to sign up to in terms of output measures. We support output measures and have supported Ofgem throughout this process in this area but if companies are asked to bear the risk of both outputs and price effects this dramatically increases risk and reduces expected returns. Nor do we accept that this issue is covered by the Information Quality Incentive mechanism given the scale of risk that shareholders would still bear for commodity prices that are largely out with their control.

We have previously proposed a form of indexation related to a basket of indicators for RPEs, which would operate beyond an appropriate threshold. We envisaged such a mechanism would operate symmetrically and protect both consumers and companies. Alternatively an "iDOK" type mechanism such as is in place for the Water companies could provide a solution.

In an update[1] for the ENA, First Economics summarise recent data on wage inflation:

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

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

Note: the data in the table has been aligned to give a consistent picture at a specific point in time. There are later figures for some of these indices, but we do not show them in the table so as to ensure a like-for-like comparison.

First Economics comment:

[1] First Economics (2009) "Forecasting Wage Inflation", September

"The table shows gives a clear sense of a differential in DNO wage inflation as at the latest date for which figures for a full set of figures are available. It is also worth noting that the BEAMA index has continued to grow at a constant level since the cut-off date for the table: the provisional September 2009 release has annual wage inflation for electrical engineers running at 3.7%, which we suspect will turn out to represent a widening of the differential to average earnings growth when data from the ONS series becomes available.

First Economics conclude:
"The analysis in this paper has highlighted what we think are two errors in Ofgem's initial proposals: the assumption that wage inflation affecting DNO costs will match economy-wide average earnings growth; and the assumption that average annual earnings growth in steady state is 3.7%.

Our recommendations are that Ofgem ought to:

- allow a premium to average earnings growth for workers with scarce infrastructure skills, consistent with the premia that are apparent in table 1 and consistent with the logically better position that such workers find themselves in relative to the average employee during a period of recession; and
- ensure that its forecasts for average earnings growth trend back to 4.25%."

General wage inflation

	Average earnings growth
pre-2008	4.25%
2008/09	3.5%
2009/10	2.5%
2010/11	3%
2011/12 and after	4.25%

2.3 COST OF CAPITAL

Refraining from publishing more definitive proposals on the allowed cost of capital and financeability measures is unhelpful and we believe constitutes poor process at this stage in the Review. Stakeholders have been denied the opportunity to respond to Ofgem's position and DNOs will be simply faced with the stark choice between accepting the Final Proposals or appealing to the Competition Commission. We are very concerned that the heightened emphasis on the interdependency of DNO's cost of capital with other risk characteristics of the overall package reduces meaningful stakeholder engagement. Investors in particular need to clearly understand their expected returns and will understandably focus on the headline cost of capital. We are of the view that the price control settlement should be calibrated such that an averagely efficient DNO can recover its actual cost of capital with no windfall gains or losses from poorly designed or indeed intentionally generous or punitive incentive mechanisms. Any departure from this in itself represents heightened regulatory risk.

We would urge Ofgem to publish more definitive views on the cost of capital and financeability as part of any Autumn update.

We note there has been a significant and sustained adverse reaction to Ofwat's proposed WACC in its Draft Determinations for PR09, in the water sector. This market evidence and associated analysis and comment by market participants provide direct feedback on Ofwat's proposals. We are also aware that Water UK has sponsored a further Investor Survey, following the publication of Ofwat's Draft Determinations, the results of which are expected to be published around the end of September.

92/09 Ch3 Q3: What are your views on PwC's range for WACC?

Cost of capital: We see no case to reduce the current cost of capital and every case to increase the rate of return given current market conditions, international competition for investors funds and the scale of the investment to be undertaken.

This has been underlined by the economic data we have submitted to date, by an Investor Survey undertaken by the ENA on behalf of the DNOs and most tangibly by reading across from the recent negative impact on the share price of those Water companies, that remain listed in the UK, following Ofwat's initial proposals for price controls in 2010-2015 determination.

We are concerned that Ofgem did not provide their view on the range for the WACC and instead relied on an extremely wide and unhelpful range provided by their consultant. This means that unlike in the Water sector, and as at previous electricity reviews we are unable to effectively gauge investors' reaction and sentiment to the initial proposals.

PWC's range for the WACC is too wide to be useful. This is unhelpful for investors and other stakeholders. The excessively low value for the bottom end of the range results from combining components in inconsistent ways (e.g. assuming both the risk free rate and the equity premium are at the low end of their individual ranges).

There are major shortcomings in PWC's report as it fails to take account of current market conditions. The current macroeconomic outlook and capital market conditions remain very uncertain.

Both the forward-looking costs of equity and debt are above historic averages.

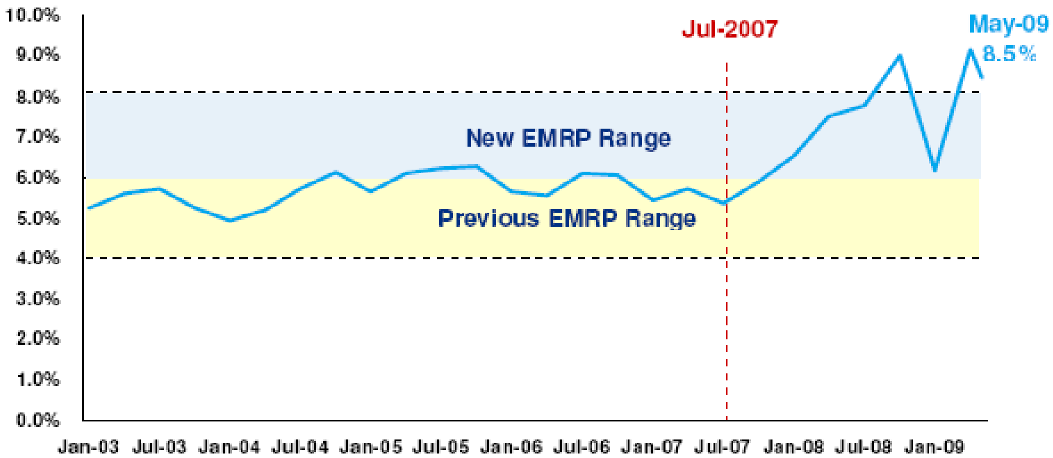
The current cost of equity is higher than the historic average. The current cost of equity should be weighted at least 50%, as the effects of the credit crunch and recession are expected to persist well into the DPCR5 period.

The current cost of debt is also higher than the historic average. The weighting on the current cost of debt should reflect the proportion of total debt that has to be raised or re-financed during DPCR5. This is estimated to be at least 30%

The forward-looking equity risk premium is significantly higher than the historical average, which PWC have assumed. This is supported by both references to the current equity risk premium in analysts' reports and NERA's Dividend Growth Model (DGM) analysis. These indicate that the forward looking risk premium is in the range 7.2% to 9.5%, having risen by 1.7 to 3.3 percentage points since the collapse of Lehman Brothers.

Analysts have increased the equity market risk premium, which they use, since the onset of the credit crunch and, especially, since the collapse of Lehman Brothers. For example, Citi's view of the equity market risk premium has increased by 2 to 3.5 percentage points since July 2007.

Equity Market Risk Premium



Source: Citi

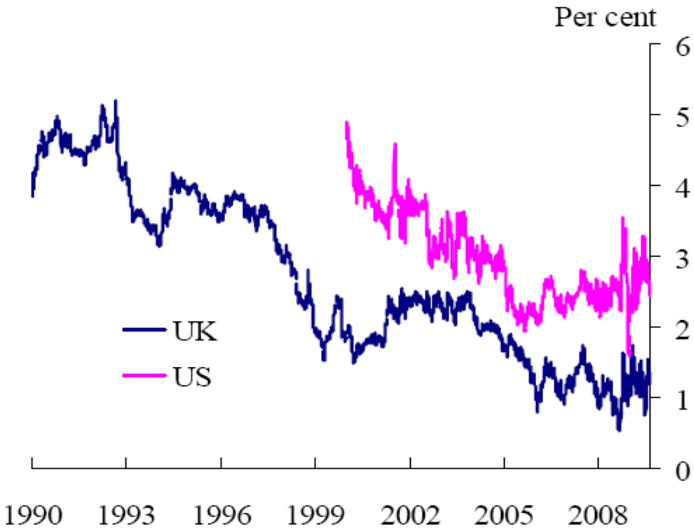
Initial findings from the Investor Survey, sponsored by Ofgem and the ENA, are that the equity risk premium has increased since DPCR4 and that equity investors believe that the current cost of equity is far higher than PWC's range, and is between 9% and 9.5%.

There is considerable uncertainty about the risk free rate due to:

- Extreme volatility in financial markets
- Negative RPI inflation measures and expectations
- Distortions to index linked yields arising from pensions regulations and accounting standards
- Impact of quantitative easing

The Deputy Governor for Monetary Policy at the Bank of England has very recently observed[2] that quantitative easing has reduced the yield on government bond yields some 50-75 basis points below what they would otherwise be.

Bank of England calculations for real 8.5 year government forward rates are now around 1.3% in the UK and around 2.5% in the US, where there is much less distortion from the demand from pension funds.



Real 8.5 year government forward rates
Source: Bloomberg and Bank of England calculations

PWC do not take account of the forward-looking cost of debt, which is also above historic averages. DNOs will have to both raise new and refinance substantial amounts of debt during DPCR5, which will not be available at lower historic rates.

Coupons on new A rated sterling bond issues by utilities this year have been between 5.1% and 7.5%, with the upper end of the range being the cost of new long tenor bonds. Although the nominal cost of new bond issues is now below the peak in late 2008, this does not mean that the real cost of debt is lower. Inflation expectations have also decreased, with the near term outlook for significant negative change in the RPI and considerable uncertainty surrounding medium to long term inflation forecasts. However, assuming that short term RPI inflation averages 1.5%, rising to 2.5% in the longer term, suggests that the real cost of debt is currently in the range

[2] Bean, Charles (2009) "The Great Moderation, the Great Panic and the Great Contraction", Schumpeter Lecture, Annual Congress of the European Economic Association, Barcelona, 25 August

3.6% to 5%, which is well above historic averages. Initial findings from the ENA Investor Survey indicate that in the views of debt analysts and lenders the current real cost of debt is in the range of 4.0% to 4.5%.

DNOs currently face higher fees for refinancing and the provision of commitment and liquidity facilities. These do not appear to have been considered.

Setting a lower cost of debt would put pressure on DNOs to unduly concentrate on raising debt with short maturities. This would then be mis-matched against long asset lives and increase re-financing risk.

The UK is facing an extremely large infrastructure investment programme, estimated to be around £500bn[3], which will require additional amounts of debt to be raised, in addition to the re-financing of existing debt. This will take place at a time when the UK government will be issuing huge amounts of gilts to fund the deficit in public finances. This unprecedented demand for debt will mean that the DNOs will be competing for funds with the government, public sector bodies and other utilities, which will lead to less favourable terms being available from lenders.

The initial results of the Ofgem/ DNO sponsored Investor Survey emphatically supports SPEN's position.

Investors were invited to provide views on the cost of capital and financeability issues as discussed within the Initial Proposals. Investors believe that the PWC range was too wide to be of use in fully assessing the proposal and were concerned by the increased emphasis on the interdependencies between cost of capital and other area of potential out/ under performance. One investor noted that investors focus on a firm outcome of WACC rather than the potential benefits from incentive schemes

Investors believe that the cost of debt suggested by PWC's range of 3.1% to 4.0% is too low. They say that the current cost of debt is between 3.75% and 4.75% and that the cost of debt during DPCR5 will be significantly higher than PWC's 'high end' 4.0%. Concerns were expressed about the future debt funding environment although a debt analysts noted that utilities tend to be able to access debt markets even when the environment is difficult.

Investors believe that the cost of equity suggested by PWC's range of 4.0% to 8.5% is too low. They say that the current cost of equity is above 9% with the equity risk premium being unanimously seen as being higher than that seen at DPCR4.

[3] Helm, D, Wardlow J and Caldecott, B (2009) "Delivering a 21st Century Infrastructure for Britain", Policy Exchange, September

One of the ratings agency believe that financeability tests should include PMICR and that Ofgem and that existing ratio thresholds were too aggressive to achieve A-/BBB+.

In general, investors are concerned by current and what are believed to be enduring volatility and uncertainty in financial markets.

2.3.1 DEBT UNCERTAINTY

92/09 Ch3 Q4: *Do you think we need a mechanism to address cost of debt uncertainty?*

We do not see the need for a debt trigger mechanism provided that the cost of debt for DPCR5 is set at an adequate level. We agree with the Competition Commission's view that companies are in a better position than most customers to manage interest rate risk.

Also, a debt-trigger would have poor incentive properties, as it may encourage companies to track the index designated, rather than reduce the overall cost of debt through effective treasury management.

In any case, constructing an accurate index of the cost of debt would be difficult. Analysis undertaken for us by CEPA shows that candidate indices can vary by several tens of basis points and many potential components are only available through proprietary data services, which would result in a lack of transparency.

CEPA's analysis also highlights that the revenue adjustment mechanism would be potentially complicated if applied frequently.

92/09 Ch3 Q5: What are your views on the debt trigger mechanism?

As we do not support the introduction of a debt-trigger mechanism for DPCR5 we have not developed our views on the detailed construction of such a mechanism.

2.4 FINANCEABILITY

In August, Moody's issued an updated rating methodology for regulated electric and gas networks which clearly stated their key credit metrics. The two major ratios are an Interest Cover measure and Net Debt / RAV. Moody's "believes that EBITDA- or FFO-based interest cover ratios are inferior indicators of the ability and flexibility of regulated networks to meet their debt service commitments[4]". Moody's formula for the Adjusted Interest Cover Ratio is:

$$\frac{\text{FFO} + (\text{Net Interest} - \text{Non-Cash Interest}) - \text{Capital Charges}}{(\text{Net Interest} - \text{Non-cash Interest})}$$

For an A grade credit rating Moody's sets a range of 2.0x to 4.0x for the Adjusted Interest Cover Ratio and 45% to 60% for Net Debt / RAV. The other two ratios that they use are FFO / Net Debt and RCF / Capex, although these are given less weight.

In response to the ENA Investor Survey one credit rating agency has indicated that, in addition, Ofgem should use PMICR of 1.5x to 2.0x.

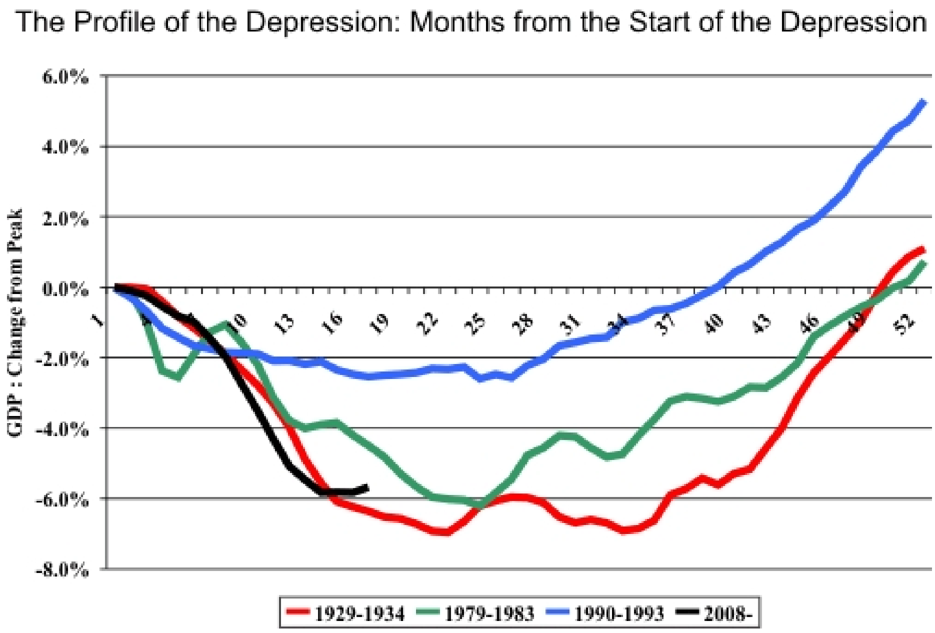
Together, these demonstrate that the majority of credit rating agencies use a form of adjusted interest cover ratios. Ofgem must include adjusted interest cover in its key ratios.

As Ofgem's target ratios are not consistent with current credit ratings, Ofgem appear to consider that a BBB+ credit rating would be sufficient. However, this would be sub-optimal and result in a significantly higher cost of debt.

The current economic recession has been the sharpest on record and it will be well into DPCR5 before the UK economy recovers to 2008 levels of output. The NIESR has recently warned[5] "There may well be a period of stagnation now, with output rising in some months and falling in others; the end of the recession should not be confused with a return to normal economic conditions"

[4] Moody's Investor Services (2009) "Rating Methodology – Regulated Electric and Gas Networks, August, p18

[5] NIESR (2009) "Monthly Estimates of GDP – August 2009", September 8th



Source: NIESR

The latest forecasts[6] from the OECD have increased the projected depth of the contraction of the UK economy in 2009 to 4.9% and forecast a protracted recovery.

Initial findings from the ENA Investor Survey demonstrate that investors are especially aware of the macro-economic background and have concerns over the funding environment for DNOs in the DPCR5 period. Ofgem must take account of the current capital market and economic conditions when setting the allowed WACC for DPCR5.

In general we are supportive of the NERA report which expands and further develops many of these issues and which is available as an associated document to the Initial Proposals.

2.5 CALIBRATION OF PRICE CONTROL

92/09 Ch4 Q1*: Do you agree with our approach to calibrating the price control settlement?*

CALIBRATION / INCENTIVES: the potential to earn returns beyond the headline cost of capital should not be seen as a substitute for getting the headline rate of return correct in the first place. To be clear, the headline rate must match what an investor expects for a company that meets its targets and commitments to customers while maintaining its credit rating and <u>before</u> taking any out-performance into account.

[6] OECD (2009) "What is the economic outlook for OECD countries: an interim assessment", 3 September

Ofgem has highlighted the unintended consequences (whether positive or negative) on companies' results from incentive mechanisms during DPCR4. We support this area of work to understand better what potential impact could arise from incentive mechanisms. However, the potential to earn returns beyond the headline cost of capital should not be seen as a substitute for getting the actual rate of return, that an investor expects for a company that meets its targets and maintains its credit rating, correct in the first place.

We strongly believe that the price review has in fact increased risk overall given the increasing level of intrusion and complexity of incentive mechanisms. For every example of perceived de-risking, a new risk has appeared, for example the stringent performance criteria for New Connections.

Regarding risk, we disagree with Ofgem's general approach to caps and collars across all incentive mechanisms since they appear to expose companies to significant cash-flow volatility in any given year since any cap or collar is effectively applied at the end of the five-year period through a "true-up" mechanism. We believe this approach should be revised to follow the precedent set by the current quality of service mechanism.

We do not agree with Ofgem's approach. The cost of capital does not depend on the level of other allowances set by Ofgem as part of the price control. The WACC is determined by the capital market and should be calculated and set on that basis. Otherwise, DNOs will not be able to finance their activities.

Ofgem are suggesting a fundamental departure from the traditional building blocks approach and regulatory precedent in other sectors. We require a cost of capital that is exactly that, as currently understood by stakeholders, set alongside incentives for the industry that are calibrated such that an averagely efficient company earns its cost of capital. Anything less or using trade offs compromises transparency, and increases regulatory risk.

Ofgem's proposed approach fails to distinguish between diversifiable and non-diversifiable risk, which is fundamental to investors' assessment of risk. A diversified investor can spread their investments over many DNOs, thereby reducing their exposure to idiosyncratic risk to a minimum. This would substantially reduce their exposure to many of the proposed incentive mechanisms, as some DNOs would do better than others. The imposition of caps and floors on incentive mechanisms therefore has little impact on diversifiable risk.

However, the risk that DNOs will bear in DPCR5 will increase relative to that in DPCR4. Ofgem propose to introduce a number of new incentives and obligations for DPCR5, including:

- a broader customer satisfaction measure with up to 1% of revenue at risk;
- an incentive on DNOs to manage transmission exit charges for new and extended GSPs, which will increase exposure to load growth;
- new guaranteed standards of performance for new connections, which are asymmetric, as they are penalties only;
- the new output measures will reduce the flexibility of DNOs in responding to unanticipated developments.

Although Ofgem now propose to introduce a tax re-opener for DPCR5, tax increases were not perceived to be a risk at DPCR4, as there was international pressure to reduce comparative tax rates and the rapid deterioration in public finances was unforeseen. Indeed, the rate of corporation tax was reduced part-way through DPCR4. In the absence of significant risk from rising tax rates in DPCR4, there is no reason to believe it was reflected in the WACC for DPCR4. This is supported by the cost of equity for DPCR4 being set at the expected market return, without DNO specific adjustments.

92/09 Ch4 Q2: *Do you think DNOs should be awarded a low baseline WACC and be given opportunities to earn more through out performance, or a higher WACC with more limited opportunities to earn through out performance?*

For the same reasons as that explained above we support a single WACC for all DNOs. We support Ofgem's base principles regarding incentives and the specific objectives laid out in Para 4.6 of the Initial Proposals.

If incentives are not balanced, there is a risk that DNOs will choose to focus on the incentive(s) which are easiest to out-perform without necessarily improving overall outcome for customers (c.f. DPCR4 losses incentive). Encouraging such behaviour may divert resources from other activities, where customers would have greater concerns.

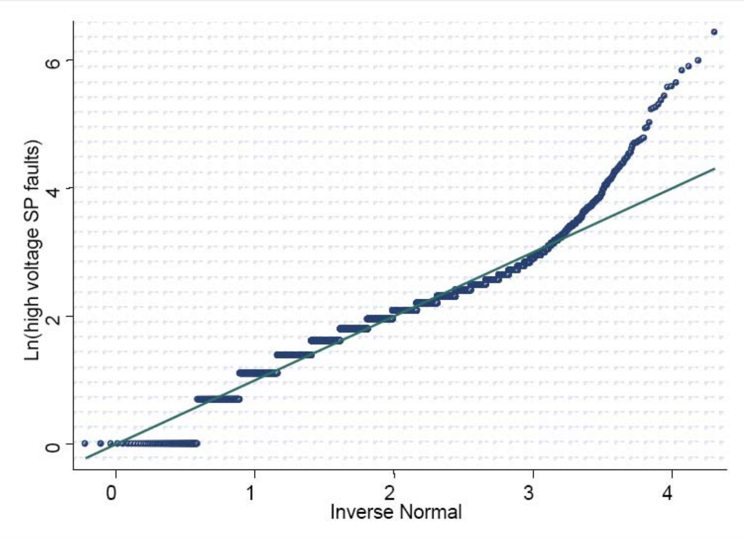
92/09 Ch4 Q3: *What comments do you have on our early views on how different incentives should be calibrated and the impact on customers' bills?*
Ofgem must share its modelling in order that DNOs and stakeholders understand the settlement if they pursue this route.

Ofgem have provided insufficient details to allow us to reproduce the results of Ofgem's Monte Carlo analysis of the impact of incentives on RORE.

However, Ofgem's analysis appears to underestimate the overall impact of the proposed incentives for DPCR5 and is potentially misleading.

Our analysis of the number and duration of interruptions has shown that the tails of the distributions are "thicker" than the log-normal distribution and that accurate modelling of their distributions requires the use of extreme value theory. In particular, the use of normal distributions will substantially underestimate the value at risk and the estimated tail loss.

The log-normal distribution is rejected by statistical tests



We have not been able to verify the impact of individual incentives. For example, the operation of the cap and floor for the losses incentive is not clearly defined (e.g. as regards the treatment of the rolling losses retention mechanisms for DPCR4 and DPCR5, which will roll into DPCR6 and, possibly, DPCR7) and their potential impact on allowed revenues within the DPCR5 period is therefore not clear. Also, the IQI matrix has not yet been finalised so the strength of the associated cost-saving incentive is not determined.

In our view, the range of outcomes from Ofgem's Monte Carlo analysis is too narrow and fails to measure the estimated tail loss, which is an important measure of value at risk. We are also of the opinion that the combined spread of the outcomes from the proposed incentives for DPCR5 would be substantially wider than Ofgem's analysis appears to indicate. In this regard we note that analysis of the correlation between extreme events is very challenging and suitable statistical techniques are still being researched[7].

Lack of clarity and transparency of the impact of incentive mechanisms within and between review periods will increase investors' perception of

[7] For example, research on multivariate extreme value theory by Professor Jonathan Tawn at the Department of Mathematics and Statistics at Lancaster University

regulatory risk. We would urge Ofgem to develop detailed draft Licence Conditions to accompany its proposals, so that their potential impact can be better assessed.
Although we support the aims of the RORE approach, the analysis needs to be refined and updated.

We are concerned by the statement in Para 4.7 that;

'Should we be put under pressure to increase our view of baseline expenditure…we may have to reconsider the calibration of incentives and other mechanism to make sure we have not made it too easy for DNOs to earn in excess of the baseline rate of return.'

This assumes that Ofgem's baseline is not flawed whereas they have already conceded it is in certain respects. It also suggests that other mechanisms have already been calibrated where they have not. Finally, it implies that Ofgem know what the baseline return is, whereas they have avoided determining this figure for the Initial Proposals by using what is only a "modelling assumption".

In principle we believe that DNOs should be incentivised to take risks over areas they can reasonably control. Rewards should be commensurate with benefits to customers.

Whilst insufficient detail has been provided by Ofgem to understand or replicate the RORE analysis that has been shown, individual incentive calibration should be assessed and set based on customer willingness to pay, benefits delivered, and degree of direct control that a DNO has.

The initial proposals include:
- IIS - clear willingness to pay, relatively high degree of DNO control, highly accurate output measure (-25to27bp proposed)
- Losses – relatively low degree of DNO control, scope for large windfall wins / gains, highly volatile output estimate (-51to50bp proposed)

The proposals run counter to the principles of WTP and good regulation to have a cap/collar for losses that is larger than IIS. ***If the losses incentive is retained for DPCR5 then the cap and collar should be no higher than (-25to 27bp) applied on an annual basis.***

The annual cap rather than a 5year cap is essential to prevent a high degree of volatility in bills for customers.

2.4.1 MECHANISMS FOR DEALING WITH UNCERTAINTY

***92/09 Ch4 Q4*:** Do you agree with our proposed mechanisms for handling uncertainty

We agree that the DPCR4 drivers for units distributed and customer numbers should be removed.

We are supportive in principle with:

- treating sole use connections as an excluded service ***(see 4.3)***
- volume drivers for high-volume low-cost connections***(see 4.3)***
- a combined re-opener for general reinforcement and high-cost connections capex involving shared assets ***(see 4.3)***
- retaining re-opener for TMA costs and the equivalent in Scotland

The Information Quality Incentive does not adequately deal with RPE uncertainty Incentive given the scale of risk that shareholders would still bear for commodity prices that are largely out with their control.

DNOs remain exposed to up to 41% of any necessary overspend (with the 59% funded ex post).

We have previously suggested (section 2.2) an indexation methodology or an ‘‘iDOK’’ mechanism. However, an alternative is that ***the IQI mechanism could be made fit to deal with RPE uncertainty by setting the incentive rate to 10% for RPE specific effects.***

SECTION 3 - INCENTIVES AND OBLIGATIONS (93/09)

3.1 Low carbon networks fund

The proposed Low carbon networks fund has the potential to be the low carbon future enabler that DNOs have been seeking. Twenty years of RPI-x regulation has created an industry focus on ever-increasing efficiency and performance challenges. In order to participate effectively in both delivery and facilitation of a low carbon future, DNOs need to change their culture, recruit and develop new skills, and change the nature of the relationship with our network users and customers.

Ofgem's primary focus in setting DPCR5 allowances is on past performance, to derive tough cost and efficiency targets, rather than equipping the companies to adapt their networks to meet the challenges of the future. This could undermine DNOs abilities to optimise the effect of this initiative.

93/09 Ch1 Q1: *Do you agree with our proposals for a new mechanism to encourage DNOs to develop their role in the low carbon economy?*

We welcome Ofgem's new LCN proposals to encourage DNOs to lead on innovative project to transfer the UK into a low carbon economy. This fund will allow technologies that are in the higher stages of their readiness (TRL 6 to 8) to be adopted and deployed into practice.

Many issues still need to be clarified with this initiative in terms of guidelines, procedures, submissions, vetting and rewards, however in principle the initiative should enable DNOs to undertake high risks projects that will assist in the assessment and implementation of low carbon technologies. This should also encourage other organisations to participate with DNOs in qualifying for additional funds and collaborative work to identify and implement projects that will have a real impact on the network and the whole of the energy chain.

The two-tier system should assist in progressing demonstrator trials into successful large-scale implementation ensuring benefits are realised through the whole value chain from renewable/embedded generation to consumers.

It is important that the details of the LCN scheme are finalised at the earliest opportunity.

93/09 Ch1 Q2: *In particular, do you agree with:*

a*) the proposed size of the funding?*

The size of the fund is substantial and we have to ensure this is spent wisely and effectively. It is also important that projects are selected properly across the UK and among all DNOs to ensure benefits are shared across the whole industry. Awarding Panel – must include senior engineers from the industry.

b) the proposals for discretionary rewards?
The rewards will be a further incentive to encourage DNOs and partners to be involved in innovative projects that are planned and managed efficiently from inception to deployment. However, a £100m discretionary award raises a number of regulatory concerns, and should only be implemented if it is subject to clearly defined application and transparent decision process.

c) the two tier structure?
This will help in trialling various technologies and focusing on ones that are most likely to succeed and generate benefits across the whole energy chain and for all stakeholders. Currently many prototype technologies exist but they are difficult to implement due to costs or suitability. The two-tier fund will assist in assessing high-risk technologies to gain a better understanding of the benefits and only then to progress to a large-scale implementation.

DNOs should be able to recover set up costs of L2 scheme development and bidding under L1

d) the proposals to recover tier 2 costs over a five-year period?
At a time when the scale of necessary investments is placing Company's balance sheets under pressure, an ex post funding arrangement is not helpful. An ex ante solution should be considered.

e) the measures to mitigate DNO risk?
In principle this is fair and acceptable but like all new initiatives there are still some unknowns about the whole process and associated risks. For instance the level of detail required in setting up Tier 2 projects and recovery of costs if projects are not successful. Some of the new technologies could be un-trialled and it could be difficult to quantify the risks and benefits of implementation. Also the impact on DNOs who do not succeed in securing funds for a project despite having put the effort and proposals for initiatives.

Introducing an obligation to allow others to trial on DNO networks has safety and cost concerns.

- The incremental cost concerns may be relatively easily addressed through introducing charges / applying contestability rules if appropriate.
- Safety and Interoperability considerations, e.g. ensuring satisfaction of the DNOs obligations under ESQCR, and contractual liabilities with our customers, present a more challenging hurdle.

93/09 Ch1 Q3: *Do you think we have adequately balanced the DNOs and customer risk?*

Although the balance of the risk is appropriate it is difficult in innovative projects to quantify the benefits and advantages in sufficient details to ensure favourable returns. In addition as the primary aim of this fund is to enable the UK to transfer to a low carbon economy it is difficult to forecast the value of carbon. For instance fault current limiters and energy storage technologies can be utilised to enable a faster penetration of distributed generations, however currently the implementation of these technologies is prohibitive due to the high costs. Hence although initially some projects might seem attractive it is possible that benefits will not be realised and therefore exposing DNOs and customers to a larger shortfall. Furthermore projects that might be unattractive in the current environment, for instance when dealing with losses, might be highly beneficial in the future. This is particularly of concern when working in Tier 2 projects where the average cost of the project is in excess of 10 Million.

Also since the process with which the Tier 2 projects are submitted is not clearly defined, it is difficult to work out how the upfront costs of these projects are funded. For instance if submissions are based on a very high level proposals without detail technical and cost benefit analysis, then such costs could be absorbed within the normal running of the DNO. However if it is expected, for Tier 2 projects, to have a detailed submission including specifications, design, project planning and cost benefit analysis, then this will require DNOs to allocate considerable amount of resources and funds to investigate the viability of such projects, including consultancy and third party costs. It is still not clear how these costs can be covered if projects are not granted.

Therefore although from the outset the risks are adequately balanced, we feel in practice some issues remain to be resolved.

93/09 Ch1 Q4: *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?*

As the benefits, knowledge and experience gained through a project will be shared and disseminated with the industry, we think the benefits accrued from a project should cover DNOs contribution and rewards. In the same way when benefits are not realised the affected DNO has to cover for 50% of the shortfall, the DNO should be rewarded accordingly if benefits are realised.

93/09 Ch1 Q5*: 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?*

Since Tier 1 projects will be allocated along the same lines as IFI projects then it is up to the DNOs to utilise then funds available to them and hence we agree with the basis of "use it or lose it". For Tier 2 projects as these will be competed for then there might be some merit in carrying the funds from one year to the next, perhaps with a cap, to give DNOs the opportunity to engage in large scale projects, if benefits can be clearly justified, or share the successes across the UK. For instance if a project in year 3 proved to be successful in with DNO A, then carrying out the similar projects in with DNO B should be encouraged to enhance the experience and gain further benefits.

For Tier 2 projects, where the average value is in excess of 10M, we think these will require time and resources to establish, evaluate and plan. Hence it will be appropriate for the funds to be ramped up annually to allow DNOs time and resources to understand the mechanism and develop projects. This trend can be noticed in the IFI funding mechanism in DPCR4 where uptake ramped year on year as DNOs established a better understanding and knowledge of the mechanism, technologies and organizations to work with.

93/09 Ch1 Q6: *Do you consider that this mechanism will achieve our stated objectives?*

The mechanism is a step in the right direction to enable DNOs to take projects from development stage to implementation and also getting the rewards for taking projects that are high risk in nature. However there are some issues that still need to be clarified, in particular:

- How are projects going to be vetted and rewarded, and apart from Ofgem who are the organisations that will assess the projects and benefits and give the go ahead. Will there be any merit for DNOs to be on the panel for determining the high value projects and how benefits are shared or transferred across the UK?
- The primary purpose of the fund is to establish projects in which innovative techniques will assist the UK to move towards a low carbon economy. It is not always possible to quantify the value add of new un-trialled technologies in terms of carbon savings or benefits realised as new technologies by nature are high risk. Furthermore it will be difficult to weigh up these projects against the value of carbon in 2015 and beyond. For instance the first mobile phone was developed in the early seventies yet it took another twenty years before benefits were realised, and the price of carbon of today might be very different to the price in 2020 hence impacting issues of losses and technology investment.
- The regulatory and commercial environment in the UK might be a barrier to some aspects of a project. For instance the current enthusiasm for

smart grid development similar to Boulder City Colorado, might not be transferable to the UK due to the completely different regulatory and commercial nature. Whilst in Boulder the whole energy chain is under one organisation, from generation to supply, in the UK there are at least four separate entities in the supply chain.

- One of the suggested purposes of the Tier 2 fund is to introduce competition between DNOs for flagship projects, and yet at the same time collaboration and total dissemination of technologies and knowledge will be required across the industry. Two points need to be considered here, first if the intention is for benefits to be shared across the industry, then there might be merit in adopting successful projects across the UK rather than avoiding duplication, second if competition is to be encouraged between DNOs then competition by nature will be prohibitive to knowledge sharing in the inception and development stages of the project, therefore it might be more beneficial if collaboration is encouraged between DNOs to establish projects together and for the funds to be shared between DNOs rather than competed for.

3.2 Provision of Information to Distributed Generation

SPEN are well placed to provide input to this as > 1/3rd of UK's renewable generation is connected to our networks, and renewable generators formed the majority of attendees at our DPCR5 stakeholder engagement events.

93/09 Ch2 Q1: *Have we correctly captured the customer's information needs?*

We agree that provision of relevant information to customers is important and consider that Ofgem have broadly captured the customer information requirements. However the challenge for DNOs is to get the balance right as there are two main consumer groups for this data - there is the small individual or company who have a specific project in mind and a small range of options open to them and there is the second group who are consultants who are marketing a service which is designed to inform developers of opportunities and the relative economics of competing sites. Both these customers require information but the level of detail that they require is likely to be different

93/09 Ch2 Q2: *Do you agree with the scope of proposed licence obligations?*

We support the view that for small scale developers (eg those intending to install microgen or a single small wind turbine) there may be an absence of information and that specific DNO based information, backed up by industry guidance would be beneficial to this group of customers.

The provision of network connection and capacity reports is heavily dependent upon the size of the installation and specifics of the connection (e.g. location and type of generation) and will involve a multi layered approach to the assessment of thermal, voltage and reverse power flow implications arising from the proposed connection. Therefore in order to provide a tailored approach as has been suggested and to make the data meaningful a relatively fine granularity in the assessment process is required. To achieve this level of granularity will have an impact upon both DNO resource and costs.

93/09 Ch2 Q3: *Do you agree with our proposal to request DNOs to commit to a strategy for information provision?*

As a DNO we agree that there should be a commitment to a strategy of information provision and look forward to engaging with Ofgem to develop this strategy.

The commitment to develop additional processes and tools to assist customers is likely to place an additional financial burden on DNOS and this should be recognised within the DPCR5 proposals.

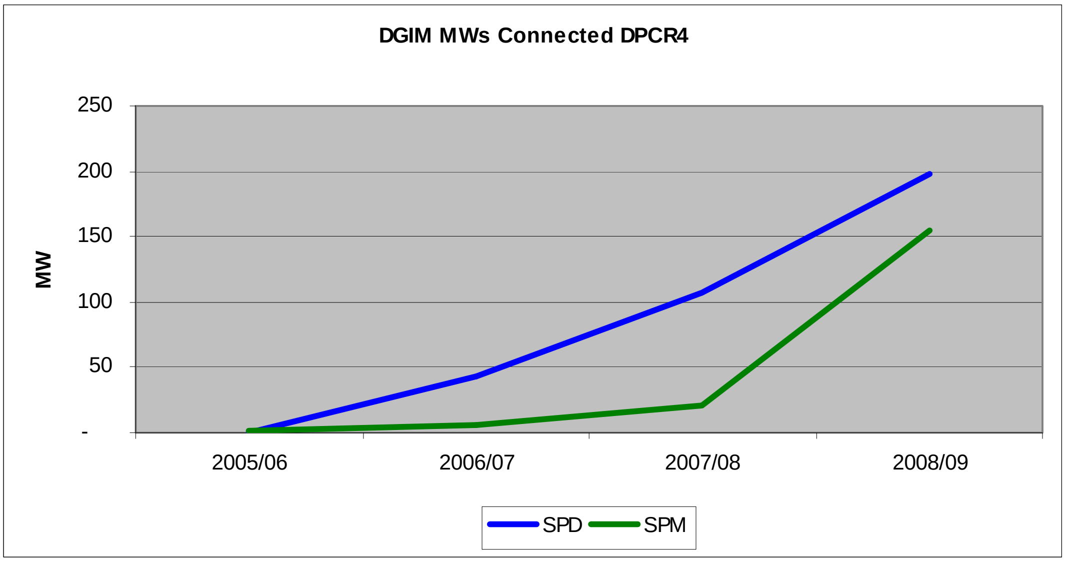
3.3 Distributed generation incentive framework

93/09 Ch3 Q1: *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?*

Scottish Power's approach in facilitating the connection of distributed generation has been to date, industry leading. We continually seek to proactively engage with all stakeholder groups and actively support government plans for UK carbon reduction by accommodating renewable generation on our distribution networks in an effective and efficient manner.

Over the course of DPCR4 we have seen an increasing trend in the level of DG connecting to our networks year on year. The lower than expected levels of DG connecting to date has primarily been as a consequence of developers taking longer than anticipated to obtain the necessary planning consents and particularly in SPD, the resolution of transmission restrictions, rather than any perceived lack of incentive on the part of the DNOs. This view was reaffirmed during the stakeholders events held as part of our DPCR5 review process.

The graph below provides a snapshot of the cumulative MWs that have connected in our distribution areas since the commencement of DPCR4:



In principle, we support the proposal to retain the DG incentive framework largely unchanged from DPCR4 however, do have some concern in respect of the detail of how it would operate during DPCR5.

We have assumed that the DG incentive value for DPCR5 of £1.00/kW/yr is in 2004 Values to be comparative with the original incentive value of £1.50 established during DPCR4, as this is not made clear in the consultation paper.

We welcome the proposal to retain the current floor and cap on DNO returns and assume that any return gained through DNO investment in use of system assets will be based upon the DNO's investment on its portfolio of distributed generation projects.

We are concerned however that any return in DPCR4 will be based upon those projects that connect prior to the end of the DPCR4 review period. This implies that projects provided with an offer to connect and where construction commences during DPCR4, but connects post 1 April 2010 will be subject to the terms of the new incentive regime. It is our view that any projects that have received a connection offer or where construction of assets has commenced during DPCR4, should be subject to the DGIM in place during that period and should form part of the DNO's portfolio at the end of the DPCR4 period.

Therefore we would conclude that the DPCR5 DG incentive and O&M allowance should only be calculated based on those projects, which are provided with a generation connection offer post 1 April 2010 and construction commences thereafter.

We welcome the intention to remove the restriction whereby the total revenue that a DNO can connect under the DG incentive regime has been recovered only from those generators connected to the distribution system after 1 April 2005. To enable the total revenue that a DNO can recover under the DG incentive scheme to be combined with the allowed demand revenue to create a single charging pot, will provide benefits to generators who are facilitating demand and in some cases deferring the requirement for reinforcement of the network.

In conclusion, we support the continuation of the DG mechanism however would caution on the implementation of any reduction in the incentive rate. Also we would wish to see a clear distinction made between those projects subject to the DG mechanism developed in DPCR4 with that of new schemes coming along throughout the forthcoming DPCR5 period.

3.4 Use of system charging to pre-2005 connected Distributed Generation

93/09 Ch4 Q1: *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 [Ofgem's/your] proposals to bring to an end the blanket exemption from use of system charges for pre-2005 connected DG and that this be applied with effect from 1 April 2010. As communicated in our information request response to [Ofgem/you], we consider there to be little (if any) difference in the rights conveyed within our Connection Agreements on DG parties connected to our networks, whether or not they were quoted pre or post April 2005. Additionally, our Use of System Methodology Statements state that, for DG connected prior to April 2005, use of system charges will be levied for those periods when they import real power, and that no charges will be levied until 2010 for periods when such sites export real power. The work to develop standardised connection contracts under the Distribution Connection and Use of System Agreement is already at an advanced stage. We continue to support this work.

Regarding the process for introducing export charges to pre 2005 DG, we believe there is a clear and simple process that can be implemented to apply where, due to the passage of time, DNOs do not have the necessary records to establish whether DG are entitled to a refund. In such circumstances the onus should be placed on pre-2005 DG connectees to formally approach the DNO with evidence that refunds of contributions should apply. Following this, and where it is determined that a refund is appropriate, the amount of the refund should qualify as DG use of system capex for inclusion in the DG mechanism.

3.5 Transmission exit charges incentive

93/09 Ch5 Q1: *Do you agree with the proposed hybrid approach for the regulatory treatment of transmission exit charges?* ***Q2****: Do you agree that in setting the scope of the incentive we targeted the appropriate cost items?* ***Q3****: Do you agree with the level of exposure under the proposed sharing factor?*

We do not agree with Ofgem's proposals for the regulatory treatment of transmission exit charges.

Ofgem have argued that an incentive mechanism is necessary as a small number of DNOs have submitted plans for significant numbers of new GSPs.

The proposals represent duplication of regulation, are disproportionate and is ***effectively a penalty only regime for those DNOs that taken a conservative view of future requirements***.

However, the proposals will present a material opportunity for out performance for those companies who have made extensive FBPQ submissions for new GSPs.

For example, SPD has submitted a forecast that includes only two GSPs that have clear and demonstrable drivers.

We have not submitted any forecast for new GSPs associated with large DG that are currently post 2015, but which may be accelerated should National Grid enable this through their queue management processes.

Should any of these be brought forward then SPD would be penalised through this mechanism. SPD has little scope for upside and unconstrained downside through this incentive.

We understand that there are a number of DNOs who have forecast no new GSPs, this mechanism would then effectively be penalty only.

3.6 Losses incentive

Ofgem provided additional detail in the initial proposals for incentivising the DNOs to manage an efficient level of losses on the networks.

We believe DNOs have a significant role to play in reducing green house gas (GHG) emissions. The industry is in a period of continued and intense asset replacement, therefore, a current material opportunity exists to achieve a reduction in GHG. However an outputs based mechanism, which utilises settlements data, does not provide an adequate framework to incentivise the necessary investment. Initiatives cannot be accurately observed and measured as an output because of underlying volatility in the settlements system.

The settlements system is designed to ensure Elexon can “procure, manage and operate the services and systems which enable the balancing and imbalance settlement of the wholesale electricity market and retail competition in electricity supply.” The settlement system was not designed and is not operated to accurately measure technical losses to such a level that supports an outputs based losses mechanism.

Incentive calibration should be assessed and set based on customer willingness to pay (WTP), benefits delivered, and degree of direct DNO control. Insufficient detail has been provided by Ofgem to understand or replicate the RORE analysis that has been shown, individual

DNOs have a relatively low degree of control over the losses incentive describe in the initial proposals due to the material impact of non technical losses. The volatility in non-technical losses allows for potential significant DNO revenue windfall wins / gains which is a risk to energy suppliers who provide fixed term contracts and customers in general. The output estimate for the incentive from the RORE analysis (-51to50bp proposed) is highly volatile. By comparison the IIS incentive has a clear customer willingness to pay, relatively high degree of DNO control, highly accurate output measure but the RORE analysis (-25to27bp proposed) indicates a much lower revenue exposure.

This is a clear indication the proposed losses incentive goes against the principles of good regulation and customer WTP. **Based on these principles a cap/collar for losses should not be larger than IIS.**

The majority of DNOs have proposed a “quasi output” approach to technical losses that is a significant advancement on the existing scheme. This approach would deliver real environmental benefits, which are a matter of physical fact.

The initial proposals describe an outputs based mechanism that is very complex. The licence drafting needs to progress significantly in the near future so clarity is provided on the exact calculation and application of the proposed losses incentive mechanism including the cap and floor.

In the initial proposals it is proposed that the cap and floor is not introduced on an annual basis. We believe an annual cap and floor is appropriate, as this would reduce exposure to settlement volatility. This is especially important during the next period as the introduction of SMART meters increase the risk of volatility. The mention in the initial proposals that an annual floor (0.5% of average units distributed) could encourage DNO to manage the timing of loss initiatives demonstrates the need for Ofgem to seek engineering input in the development of this incentive mechanism. No engineering initiatives are capable of reducing losses by such a quantum.

93/09 Ch6 Q1: *Do you agree with our proposal to provide explicit funding for justified low loss investments to provide direct recognition of the investment?*

We agree with the provision of explicit funding to support the proposed investment in low loss equipment. We are currently working with Ofgem's environmental working group staff to understand the mechanism to adjust targets.

The assessment by Ofgem of viable low loss investments to be funded in DPCR5 appears to be flawed. The cost benefits assessment approach adopted limits the benefits considered to a) the losses impact in 5 years plus b) a simulated capital overspend through IQI mechanism. This will exclude a number of investment schemes, and is inappropriate for investments that will be delivering benefits for up to 80 years.

93/09 Ch6 Q2: *Do you agree with our proposals (common reporting, reporting lag) to address the issues associated with using settlement data to measure losses?*

We do not accept that settlements data is a suitable basis for the losses incentive mechanism. The losses value as calculated by settlements is the small difference between two large numbers of which one is inherently based on estimates. Settlements data does not accurately measure physical energy exiting our system and the errors in settlements data are greater than the underlying changes in technical losses. There is a fundamental failure to recognise the difference between units unaccounted for and technical losses, which arise from physical energy flows through our networks. The focus on settlements data is inappropriate for an incentive that aims to reduce CO2 emissions. This has been clearly demonstrated by the DPCR4 losses mechanism, where most of the effort has been directed at data recording and reporting, which have no effect on CO2 emissions.

We do support the development of a common basis for reporting losses. This will hopefully help Ofgem and the industry better understand settlement volatility and assist the development of supplier / DNO initiatives to improve data quality.

If an outputs based mechanism continues in DPCR5 we believe the reporting lag should allow settlement data to reach DF. This would accommodate and fully reward revenue protection activities.

Ofgem's delay in publishing the result of its consultation on theft is regrettable as theft is an integral part of reported losses. We believe Ofgem needs to mandate the requirement that suppliers fully correct settlements data for identified theft.

93/09 Ch6 Q3: *What are your views on our proposals for a common reporting method and where we have identified options, which do you prefer?*

We strongly prefer to use the same Settlement data flows that we currently do, as we wish to avoid incurring the costs of changing our systems. We have provided Ofgem with the details of the data flows that we use. We have become aware that other DNOs may use alternative settlement data flows. Our systems are not set up to use the alternative data flows and some DNOs systems will not be set up to use the data flows we rely on. We suggest flexibility is allowed in agreeing the appropriate data flows where the source can be verified as appropriate. A change in data flows would require an extensive project to validate new data.

We are very concerned that the use of unadjusted data entering the distribution system at remote embedded generation sites would expose us to increasing losses as a result of location decisions by generators, which already face economic price signals through connection charges and the loss adjustment factors applied in Settlements. In the calculation of DNO losses, units from embedded generation should be grossed up or down to GSP equivalent using the loss adjustment factors, which are applied in Settlements and calculated in accordance with P216. If DNOs were to implement Ofgem's proposal that DNOs should be penalised for these losses, and should transfer this penalty to generators through UOS charges then generators would pay for this twice.

We believe DF runs are the only suitable data flow for use as a basis for common reporting. In normal circumstances RF may be considered, however, potential settlement volatility from the introduction of SMART metering will significantly increase risk and makes DF flows necessary. If common reporting was based on RF flows, subsequent DF runs would cast doubt on the validity of reporting.

We have a large number of IDNO and out-of-area networks operating within our licensed areas and they are growing rapidly. It is essential that IDNO boundary flows are accurately monitored. We currently meter all existing IDNO boundary flows but we have not been able to satisfactorily reconcile settlement data provided by IDNOs with our metered data. This again demonstrates that settlement data is not an accurate measure of physical energy distributed.

In addition there is significant evidence to demonstrate IDNOs infrastructure is of a higher loss nature than our existing infrastructure. For example the cables beyond our boundary are of a lower rating than we would install. Therefore without accurate metering the actions taken by DNOs to reduce losses would be negated by higher loss infrastructure installed by IDNOs.

93/09 Ch6 Q4: *Do you agree with our revised losses incentive value and our proposal to retain the rolling retention mechanism?*

We accept that the proposed £60/Mwh is a reasonable value for technical losses as these result in CO2 emissions. However, we do not accept that it is appropriate to use the same value for non-technical losses, as these do not generally result in additional CO2 emissions. We propose that the overall value should be reduced by removing the shadow price of carbon from the proportion of losses that are non-technical.

We believe a losses roller mechanism should not be introduced until the full implementation of SMART metering or other initiatives that allow units distributed to be accurately measured. In principle we agree with a rolling retention mechanism for losses performance. The mechanism will encourage loss reduction initiatives to be undertaken at any time during the period. The rolling mechanism would provide this incentive, however, currently the underlying volatility in losses masks the impact of DNO loss reduction initiatives.

93/09 Ch6 Q5: *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?*

This change is unnecessary, provides no benefits besides commonality, but introduces cost and significant transitional risk due to Ofgem's request to estimate this consumption in very short timescales.

The cost of metering in substations would not pass a cost-benefit assessment, which Ofgem should undertake as part of an impact assessment before imposing such a requirement.

If sub station usage were removed from losses an estimated adjustment to our current reported losses would be necessary to set a target. This introduces a subjective adjustment that will rely on high-level estimates. This will introduce addition risk to an outputs based incentive which will exposes the DNOs to significant potential revenue volatility.

DNOs should continue to have the option to treat substation usage as a component of losses.

The Opex allowance for DNOs would need to be adjusted, if registration of substations as UMS occurred, to reflect the associated increase in the DNO cost base.

93/09 Ch6 Q6: *Do you agree with our proposals to recognise and reward improvements to the losses measurement?*

We would continue to support industry initiatives to target and reduce theft, which is growing. However, we are concerned that supplier may not play their part in revenue protection activities, especially where there is no financial incentive for them to do so.

3.7 Treatment of DPCR4 losses rolling retention mechanism Ofgem

Ofgem has provided additional detail in the initial proposals for implementing the losses incentive rolling retention mechanism for DPCR4.

93/09 Ch7 Q1: 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?

There is significant exposure and risk placed on the DNO by the roller mechanism and in particular the material impact of potential settlement volatility in the latter years of the roller calculation. We therefore believe the roller calculation should await DF flows.

93/09 Ch7 Q2: Do you consider that the proposals for closing out the DPCR4 rolling retention mechanism have merit, and if so, how should we manage the uncertainty?

We are fundamentally opposed to the losses rolling mechanism due to the volatility of settlements data experienced during the DPCR4 period. The losses roller for the DNOs if implement as proposed will result in customers funding an incentive that in substance is a lottery. The mechanism was designed to encourage loss reduction initiatives to be undertaken at any time during the period. The rolling mechanism would provide this incentive however the underlying volatility in DPCR4 reported losses masks the impact of DNO loss reduction initiatives.

If Ofgem do not switch off the DPCR4 mechanism in recognition of the fundamental flaws with the losses roller, including the financial risk to both customers and DNOs, we believe the buy out option should be available to manage the uncertainty.

We believe the most equitable way of calculating the buy out value would be to average the losses reported to date under the DPCR4 mechanism for 2005/06 to 2008/09. This value should then be utilised for the 2009/10 field in the losses roller calculation. DNOs, energy suppliers and customers are exposed to significant financial exposure as the losses roller design is such that the 2009/10 losses value, including any settlement volatility, can materially alter the impact of the roller.

The substitution of a four year average rather than a single value, which is fully exposed to settlement volatility, is arguable more accurate and equitable than the substantive mechanism.

DNOs should have the opportunity to remove the financial uncertainty of the DPCR4 losses roller. This proposal above which allows DNOs to calculate and buy out their penalty based on the substitution of an average for the 2009/10 value would be in the interests of customers, energy suppliers and DNOs.

3.8 Business carbon footprint reporting

93/09 Ch8 Q1: *Do you agree with our proposal for BCF reporting requirements?*

In principal we agree with the proposal as long as the outputs can be achieved largely within existing data capture, collation and consolidation arrangements and resources. It would be unacceptable to need to establish additional separate data request, collation and consolidation arrangements specifically for BCF.

93/09 Ch8 Q2: *Do you agree with the proposed guidance for the BCF reporting methodology?*

In principal we agree with the guidance but the current direction to DEFRA guidance, but have concerns that the scope of normative references is too wide to provide a practicable tool. This requires the development of an industry specific tool.

The proposal to include scope three contractor emissions implies the development and implementation of Carbon Project Management Plans for each project or contract. The current proposals do not set “significance boundaries” for this activity and imply all contractor delivered activities. The requirement to report re contractor delivered activities will create an additional administrative and organizational burden on our contractors, project managers and Environmental Team. This is currently unacceptable and un-achievable.

Our current systems for supply of energy and transport data are geared to deliver bulk data with a Corporate wide scope. This has little facility for allocation to main business unit. We do not believe that this problem is insurmountable with greater refinement of existing system over times. To achieve mapping of emissions to license would also re quire estimations and further refinement of existing systems.

The proposals to register substation supplies as metered or un-metered supplies will inevitably alter the cost basis for the business. In the short term a methodology for estimation of these factors will be required, and in the medium to long-term delivery of investment programs for installation of metering.

93/09 Ch8 Q3: *Do you agree with our proposal to rely on a reputational incentive only (through publication of a league table)?*

We have no issues regarding the compilation of a league table on this issue as long as the reporting systems and methodologies are as agreed industry standard.

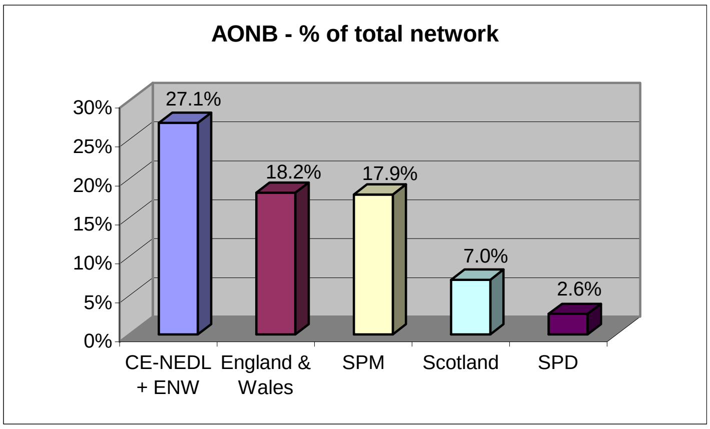
3.9 Undergrounding in Areas of Outstanding Natural Beauty ('AONBs') and National Parks mechanism

***93/09 Ch9 Q1**: Do you agree with our proposed amendments to how the undergrounding allowance is formulated?*

In principal we have no objections to the methodology adopted for the determination of the visual amenity allowance, as detailed within the DPCR5 initial proposals.

However, as previously stated within our FPBQ submission and as discussed at the recent bilateral meetings, we believe that the specific application of undergrounding to National Parks and Areas of Outstanding Natural Beauty does not accurately reflect the visual amenity within SPD's geographical area. The National Park designation, while different in detailed aims between England & Wales and Scotland, has the same broad aims. While it is clear that the National Park designation in England[8], Wales and Scotland[9] are broadly equivalent, we consider that there are differences between the English and Welsh AONB designations and the *Scottish Natural Heritage* (SNH) Local Landscape designation, resulting in areas of the Scottish Landscape, designated for its landscape quality and amenity value, not being appropriately considered.

Geographical analysis highlights that within England and Wales circa 10% of the landmass is designated as National Park and 18% as AONB. This is reflected in the subsequent % of circuits within DNO's visual amenity as detailed in Figure 1, taken from Table 9.1 Ofgem's Initial proposals –



Incentives and Obligations.

Figure 1

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[8] UK with the National Parks and Access to the Countryside Act 1949, first ten national parks were created between 1951 and 1957, the 11th in 1988, the 12th in 2005 and the 13th is proposed to be operational by 2011

[9] Under the National Parks (Scotland) Act 2000, national parks in Scotland. Loch Lomond and the Trossachs National park , created in 2002 followed subsequently by the Cairngorm national park in 2003.

Our proposal to ensure equivalence across England, Wales and Scotland landmass, reflects *Scottish Natural Heritage* (SNH) guidance given in their document Guidance on Local Landscape designations[10], Scotland methodology. As detailed in Figure 2.

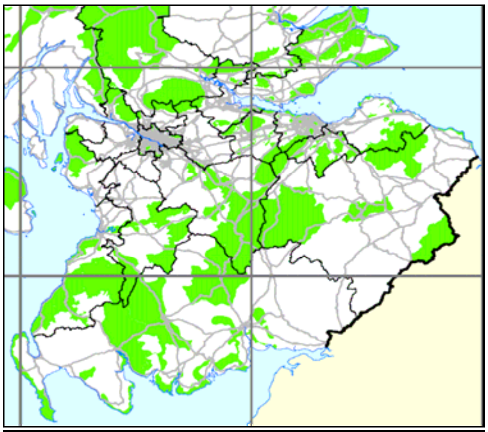

Figure 2

Within SPD we propose that 20% of the circuits fall within the equivalent SNH, Local Landscape designation areas which are varied and cover a multi faceted approach to visual ammenity. Further diaggregated informaton for SPD is detailed within Appendix 1.

We support the additional changes associated with the removal of the voltage cap. We believe will allow greater flexibility to the application of undergrounding within areas of high visual amenity.

93/09 Ch9 Q2*: Do you agree with our proposed approach to undergrounding projects not completed by the end of DPCR4?*

We note the change to the definition of the *point of completion of the undergrounding* works and are broadly supportive of this increase in flexibility, taking cognisance of the local flora and fauna.

[10] http://www.snh.org.uk/pubs/results.asp?q=Local%20Landscape%20Designations&c=-1&isbn=&o=title&submit=SEARCH

	Authority Area (ha)	Areas of Special Protection	Biosphere Reserves	Country Parks	Gardens and Designed Landscapes	Local Nature Reserves	Long Distance Routes	Marine Consultation Areas	National Nature Reserves	National Parks	National Scenic Areas	Ramsar Sites	Regional Parks	Sites of Special Scientific Interest	Special Areas of Conservation	Special Protection Areas
City of Edinburgh	27303	5	-	271	2,910	173	-	-	-	-	-	913	4,069	1,239	-	918
Clackmannanshire	16392	-	-	68	-	44	-	-	-	-	-	249	-	801	-	249
Dumfries and Galloway	667297	-	5,010	-	5,706	2,982	192	3,777	10,440	-	28,130	33,706	-	75,207	91,963	48,713
East Ayrshire	127033	-	-	81	2,029	7	-	-	-	-	-	-	-	18,482	2,739	16,663
East Dunbartonshire	17461	-	-	-	-	21	3	-	-	-	-	-	-	137	-	-
East Lothian	70092	-	-	675	4,766	582	-	-	-	-	-	1,934	-	4,674	-	1,963
East Renfrewshire	17379	-	-	-	8	-	-	-	-	-	-	-	-	91	-	-
Falkirk	31489	-	-	61	492	29	-	-	-	-	-	1,439	-	1,925	3	1,521
Fife	137385	-	-	489	4,179	1,650	-	-	620	-	-	4,270	6,058	7,714	3,244	4,342
Glasgow City	17736	28	-	146	510	246	-	-	-	-	-	-	-	149	-	-
Inverclyde	17356	-	-	-	424	44	-	-	-	-	-	107	7,858	4,534	-	3,763
Midlothian	35528	-	-	143	2,547	5	-	-	-	-	-	504	4,187	1,200	53	504
North Ayrshire	90384	4	-	477	1,150	12	-	2,823	10	-	23,415	-	17,181	26,468	143	13,972
North Lanarkshire	47213	-	-	1,016	224	59	-	-	-	-	-	-	-	1,000	213	509
Renfrewshire	26875	-	-	692	224	17	-	-	-	-	-	558	4,157	3,154	-	2,666
Scottish Borders	474263	-	-	-	7,832	-	145	4,838	136	-	16,647	348	-	28,519	13,133	4,093
South Ayrshire	123469	2	-	229	1,907	-	-	383	-	-	-	-	-	6,479	1,576	2,713
South Lanarkshire	177405	136	-	616	2,610	20	14	-	348	-	-	-	-	9,154	1,093	4,420
Stirling	225481	-	-	206	2,676	6	77	-	2,537	117,926	17,610	116	14,803	18,528	8,564	212
West Dunbartonshire	18278	-	-	81	312	19	-	-	198	5,558	3,406	431	5,691	1,220	47	458
West Lothian	43162	-	-	479	667	143	-	-	108	-	-	146	998	1,287	146	146
Totals (ha)	2408981	**175**	**5,010**	**5,730**	**41,174**	**6,058**	**432**	**11,821**	**14,398**	**123,484**	**89,208**	**44,721**	**65,001**	**211,961**	**122,916**	**107,826**

3.10 Connections incentives and obligations

In para 2.3 of the main consultation document Ofgem state that they 'have tried to make sure the regulatory framework is not overly complicated'. However, the DPCR5 initial proposals represent an ambitious expansion of the regulatory contract between Ofgem and DNOs, with unprecedented proposals for changes to incentives and reporting. Many of these will prove challenging to implement for 1 April 2010, and their implementation costs have been excluded from the operating cost assessments. These new costs must be factored into company's allowances and where appropriate the more complex of the new requirements (e.g. connections reporting) should be phased in over the first 2 years of the price control.

A pragmatic approach has not been applied to Ofgem's proposals for new connections (including Guaranteed Standards and 4% margin for certain activities). The proposals demonstrate no cognisance of the complexity and scale of system and process changes that will be required.

These should be introduced in a more controlled manner over the first 2 years of the price control, and the incremental costs should be funded through the operating cost allowance.

With regards to the connections proposals we believe SPEN are best placed to comment of all DNOS having facilitated the most effective levels of competition in connection in the UK that in some market segments far exceed the competition tests applied to the Energy Retail markets by Ofgem. Compare, for example, the proposed HHI figure of 1000 for 'high volume' connections with the GB regional HHI average in electricity supply of 3,356 and 3,036 for gas, as quoted in Ofgem's October 2008 Energy Supply Probe Initial Report. This report also contained figures for national HHIs in retail electricity and gas of 1,735 and 2,625 respectively, again well above the figure now proposed in respect of electricity connections.

A fundamental review of the connections market is necessary which recognises that in the main the connecting party is not the enduring customer, and in many instances there are conflicting interests.

It is necessary to draw a distinction between these categories of customers (competitive connections providers/developers versus enduring customers) and ensure that the CinC market does not disadvantage the customer who will be connected to the connection assets for the next 40 years.

Proposals will introduce significant administrative costs, and will necessitate that companies need to introduce stricter standards around customer requirements and are likely to lead to reduced flexibility for customers.

Ofgem's proposals to introduce a 4% margin for contestable connections works are welcome in principle but flawed in their proposed application.

Significant changes will be necessary to quoting and IT systems to record the information necessary to report as Ofgem have proposed.

To be more effective this margin should be applied to all contestable activities where a DNO has demonstrated effective competition across the market as a whole, rather than individually to each market segment demonstrated to be competitive.

The market tests to be applied to demonstrate effective competition should be equivalent to those used by Ofgem to test the effectiveness of the Energy Retail Markets when removing price caps.

Associated with this Ofgem's proposal to remove margin from diversionary works is inappropriate. In SPEN areas significant proportions of this activity are contestable and delivered in this manner. There is no justification for this change.

93/09 Ch10 Q1: *Do you agree with the scope, timeframes and the level of penalties proposed for the guaranteed standards regime?*

We agree that the standards broadly cover the areas likely to be of most concern to customers. However, it is critical that the exemptions regime ensures that licensees are not exposed to penalties due to factors outside their control (e.g. delays in obtaining wayleaves/easements and planning consents). It also needs to satisfactorily take into account actions that the customer must perform prior to the connection being made;
We are also concerned at the complexity of the standards, with up to three 'delivery' standards for each connection, and more than 20 standards overall for metered connections alone. At a minimum, consideration should be given to merging proposed standards using the upper working day period where there is relatively little difference between the working day requirements.
It should also be taken into account that customers for larger projects, including housing developments, are often not willing to discuss detailed connection schedules at an early stage following acceptance of the quotation. It would be more appropriate in such cases for the licensee to be required to arrange connection dates at the customer's request.

Implementation of the standards should be phased. Whilst competition in the SPEN areas is the most effective in the UK, SP Distributions c.40% market share still represents 9,000 section 16 ('licensed') connections a year, the majority of which will be low volume connections. The standards provide

for up to 6 actions for each connection (budget quote, formal quote, contact to arrange works, commence works, carry out connection works, carry out energisation works) with the need to record clock start/clock stop/clock pause events, and also possible changes. It will take time to establish auditable systems and train staff to provide for payments or exclusions for each element within each voltage category. It is not practicable to achieve this by April 2010. We propose that new standards should not apply until December 2010 at the earliest in order to allow companies sufficient time to establish appropriate arrangements. It is also important that companies are allowed to recover the reasonable costs of establishing systems and resource arrangements to administer the standards.
Levels of penalties – subject to phasing and satisfactory exemptions regime, penalties are acceptable.
Transitional issues – we propose that existing schemes are not subject to the standards so long as the quotation has been accepted prior to the standards coming into force.

93/09 Ch10 Q2: *Should we develop a mechanism to ramp up the level of the proposed penalty payments?*

We have not seen a case for this particularly given the 90% performance proposal.

93/09 Ch10 Q3*: Should we cap the penalties that apply to each of the proposed standards?*

This is subject to a satisfactory exemptions regime. A cap should apply if the DNO is exposed to penalties due to the behaviour of the customer or his agent or third parties;

93/09 Ch10 Q4: *Should we apply in aggregate a 90 per cent performance target to apply to the standards and measure this on a quarterly basis?*

We are highly concerned at the 'triple jeopardy' to DNOs engendered by mandatory 90% performance targets – namely possible enforcement action if the target is not met, coupled with the link to competition tests and possible CC referral, together with the penalties stemming from GS failures;

We do not support quarterly measurement against the standard – this would force DNOs to apply an extremely rigid approach in providing connection services in order to protect itself to the fullest extent possible. We doubt that customers will appreciate the loss of flexibility and withdrawal of goodwill implied by such a regime. . It will also involve further costs to companies in administering and reporting against such a scheme.

93/09 Ch10 Q5*: 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?*

The market segments seem to broadly reflect competitive categories of connection. We note that there are a number of differences from the categories used for guaranteed standards, for example in respect of unmetered connections, and the reasons for this are not clear.

We are concerned that 'voluntary' application of GS payments to ICPs is given status of competition test that a DNO must pass, and furthermore is grouped with tests of performance against standards regime;

Treatment of Diversion Works (see section 5.3 also)
Diversion works are contestable where physically and electrically separate from DNOs' network, and as a consequence are delivered in line with the industry leading levels of competition in connection in the SPEN areas. We do not accept that in majority of cases the DNO must carry these out. These are not 'modified connections' and should not be treated as such. It is not reasonable to disallow margins.

93/09 Ch10 Q6: *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?*

DNOs do not have a ready means of measuring contestable costs for connections; Whilst quotes > £20,000 are split on a contestable / non-contestable basis these costs are only split within individual quotations. There has been no need historically to track these costs in these categories.

We note that margin is only to apply to direct contestable costs. However, presumably contractor margins of 4.9% quoted in paragraph 10.10 apply to total charges. This should be taken into account before margin is determined.

Administration of 'clawback' of margins in repayments to the 'customer that incurred them' (paragraph 10.37) will be highly resource intensive. This proposal is not practicable or likely to be fair to customers and we do not support it.

93/09 Ch10 Q7: *Do you have any comments on the scope of the proposed competition tests?*

A number of aspects of the tests are unclear – for example the status of the "Pure Competition Tests" and whether a DNO exceeding one or both *thresholds in a particular segment X will face disallowance of margins and possible CC referral even if other tests are met;* ***it is important that precise mechanism is clarified prior to final proposals.***

It also remains unclear how individual tests will be balanced one with another and between test categories

We do not agree with the proposal that one of the tests should be whether or not 'voluntary' guaranteed standards are applied to ICPs. DNOs are already subject to performance standards in providing non-contestable services to ICPs. It is inappropriate to apply a test of 'voluntary' penalty payments to ICPs in determining whether or not a DNO is permitted to charge or retain a regulated margin on section 16 connections.

93/09 Ch10 Q8: *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?*

It not clear what is meant by 'weighting' in this context. See comment on question 7. The proposed HHI figure of 1000 would mean that a DNO with a market share of more than around 30% in any "high volume" segment would fail the competition test. This is unrealistic and should be reconsidered. This proposed test does not align with competition tests applied by Ofgem in assessing effectiveness of other liberalised activities, e.g. electricity retail prior to removing price caps.

3.11 Broad measure of customer satisfaction

93/09 Ch11 Q1: *Do you agree with the proposed scope of the broader measure?*

We continue to support Ofgem's proposals to introduce a broad measure of customer satisfaction, and will continue to work in and through the CIWG to develop the detailed requirements of this measure. We acknowledge that a number of the points provided in our response to the December paper have been recognised and included in the updated proposals.

We agree that the use of objective measures, where practicable, is the preferred approach and that such measures provide relevant, cost effective and timely feedback for DNOs.

93/09 Ch11 Q2: *Do you agree with the revenue exposure and the incentive weightings proposed for each element?*

In comparison to the current Telephony Incentive Scheme the proposed revenue exposure, reflecting the expansive nature of this new measure, is broadly appropriate. However we do not see a case for the imbalance created by the offsetting of the avoidance of penalty for "stakeholder engagement", as it merely transfers the risk to the other contributing metrics. We believe that the customer satisfaction survey and complaints incentives should be symmetric rather than skewed in the way proposed. This would mean that the overall financial scope of the measure should be +1%/-0.8% of revenue exposure.

We believe that the current Telephony Incentive Scheme methodology, including the deadband has worked well, encouraging DNOs to strive to outperform and achieve additional returns while limiting the impact of volatility in survey results. We would support such an approach for the new scheme.

3.12 Telephony incentive scheme

93/09 Ch12 Q1: *Do you agree with the proposed improvements to the telephony scheme?*

We agree with the proposed improvements for the telephony scheme. We recognise that while it will be absorbed into the broader Customer Satisfaction Scheme, that the refinement to the attributes continues to be a positive step. We also support the introduction of the “unsuccessful calls” and the associated weighting approach.

93/09 Ch12 Q2: *Do you agree with our proposals and methodology for recasting the reward and penalty thresholds?*

We agree with the proposals and the recasting of the reward and penalty thresholds to appropriately reflect the inclusion of “unsuccessful calls” into the scheme. They will continue to provide the opportunity to achieve as a minimum an acceptable outcome.

3.13 Worst served customers

***93/09 Ch13 Q*1:** Do you agree with the proposed mechanism (in full) for worst served customers?

No. While we recognise the requirement to target this customer group we still consider that the Ofgem proposals do not go far enough. It is our view that any additional allowance should be ex-ante fixed, and not assessed against performance criteria.

However we will utilise this mechanism to provide an improved service to those affected customers and are willing to work with Ofgem to review, develop or improve this mechanism through DPCR5.

***93/09 Ch13 Q*2:** Do you agree with the level of the proposed cap per benefiting customer? If not, what level do you believe is appropriate?

No. We continue to believe the proposed cap to be too low and that a reasonable level would be £2000, or indeed unlimited, to improve customers experience under this mechanism.

3.14 Interruptions Incentive Scheme (IIS)

93/09 Ch14 Q1: *Do you agree with the proposal that any required improvement from current performance levels should be funded by shareholders?*

No. We believe that leading performance companies have been previously funded by the regulatory mechanisms to develop their network to provide current levels of performance. To propose that shareholder should now fund improvements is inconsistent with historic strategy. Any required improvements should be funded by appropriate allowances.

93/09 Ch14 Q2: *Do you agree with the approach to setting pre-arranged allowances?*

While the principle applied to develop the Pre-arranged allowances, the use of that used for the ESQCR re-opener, is acceptable the wide range of proposed costs included in the approach introduces an inaccurate representation of the work that will affect customers through Pre-arranged outage requirements. Typically work undertaken on 132/33kV assets will not require CI/CML allowances, and as such any funding included in the development of these allowances should be excluded, with the focus being placed upon those work areas that are relevant to the areas that define the Pre-Arranged allowances.

We do not support the proposal for a 5-year ‘pot’ for Pre-Arranged allowances. Our preference would be for the annual CI/CML allowances as proposed by the DNO, or revised as per benchmarking, to be the yearly allowances, as per DPCR4. We also support the continued use of a 50% weighting to reflect the planned aspect of this allowance provision. This approach provides the DNO with a manageable yearly risk exposure that is reflective of the approach proposed for unplanned targets. See the answer to Q3.

With regards to the cumulative aspect of impact of the allowances over the complete 5 years it is our view that a yearly cap/collar should continue to be utilised, as per DPCR4, with no roll forward. This provides the DNO with a manageable yearly risk exposure that is reflective of the approach proposed for unplanned targets. See the answer to Q3.

93/09 Ch14 Q3: *Do you agree with the proposed levels of revenue exposure and incentive rates?*

We agree that the overall 3% range should be retained. The proposed change to the revenue split, 0.8/2.2%, recognises the customer’s expectations, re their WTP feedback, in the current climate. We would consider it reasonable to review this aspect for future price reviews.

We fully support the Investment Rates properly reflecting customer WTP. However the Ofgem analysis of how each group affects the outcome is, in our view, imbalanced as the influence of S/M/L business WTP contributions unreasonably influences the outcomes at present. It is our intention to work with Ofgem to improve the analysis to better reflect the overall customer base WTP proposals in advance of the Final Proposals.

With regards to the proposal for accumulating revenue exposure into a single 5-year settlement it is our view that this approach should be re-considered. We propose the retention of a 3% yearly cap/collar arrangement, with performance in excess of this limit rolled into the settlement of the following year. This approach will achieve Ofgem's desire to evaluate performance over the entire period with a final year 'true-up' still being achieved. In addition this will provide for a more stable impact on customer facing costs year-on-year.

93/09 Ch14 Q4: *Do you agree with the proposed refinements to the exceptional events mechanism?*

We agree with the changes proposed to the severe weather event thresholds. We broadly agree with the proposals for the one-off exceptional events, with the specific introduction of asset failures being considered, however there is no explicit mention of Grid Code obligations being included. This was suggested in the May paper, and we would expect to be included in any drafting of licence changes.

3.15 Guaranteed standards of performance (non connections related)

93/09 Ch15 Q1: *Do you agree with the proposal to increase guaranteed standard payment levels to reflect inflation?*

Yes.

93/09 Ch15 Q2: *Do you agree with the proposal to introduce some form of payment cap for large one-off events?*

We support the introduction of a payment cap for large one-off events.

93/09 Ch15 Q3: *If you agree to the introduction of some form of payment cap, what is your preferred method?*

The introduction of a payment cap should reflect the financial impact across the whole year, and as result there should be a cumulative annual cap of 2% total company revenue exposure, in addition to a limit of £200 per customer.

93/09 Ch15 Q4: *Do you agree that rota disconnection interruptions should be treated independently of the multiple interruption standard?*

Supply interruptions that result from rota disconnections should be treated independently from the multiple interruptions standard, hence be excluded from contributing to any associated payments.

3.16 Customer Service Reward Scheme

93/09 Ch16 Q1: *Do you agree with our proposals for embedding DPCR4 best practice?*

While we continue to agree with the principle of this scheme we remain concerned. Not all of the best practice identified from DPCR4 will be suitable for all DNOs therefore a degree of flexibility is definitely required in determining specific practices as well as the proposed minimum requirements.

93/09 Ch16 Q2: *Do you agree that the scheme should be rationalised once the Broad Measure goes live in April 2012? If so, in which areas?*

We agree that as the Broad Measures Scheme is further developed that this Customer Service Reward Scheme should be rationalised to reflect the introduction of some existing areas into other arrangements.

3.17 Network Output Measures

93/09 Ch17 Q1: *Is our proposed common methodology for network output measures related to general reinforcement and asset replacement expenditure appropriate?*

The common methodology is appropriate as it provides measures for general reinforcement and asset replacement that demonstrate the health of the network and provide visibility of the impact of capital expenditure in these areas. It should be recognised that within the context of common methodology the definition of a specific health or load index differs between DNOs due to the specific details of their asset base, asset management approach and attitude to risk.

Ofgem have accepted that, for the DPCR5 settlement, DNOs may adopt thresholds and weightings in defining outputs suited to their own network. However, it is fundamental that this flexibility is retained going forward as the asset management approach of DNOs will differ and the output measures need to reflect this. Although this means that output measures are not directly comparable across DNOs it ensures that DNOs performance against the outputs can be easily measured. It will also avoid a situation where one DNO could be punished for under delivery despite reducing its level of health index four assets while another DNO is not punished despite only maintaining its level of health index five assets.

We support the view that output measures are not required for other areas of investment. The suite of existing output measures has been developed over a short space of time and the benefit and impact of the measures should be reviewed, after a suitable period of use, before consideration is given to extending the measures into other areas. While it is desirable to have output measures covering all areas of investment they need to provide a delicate balance between providing visibility of the impact of investment and allowing DNOs the flexibility to effectively manage their asset base and develop innovative approaches to deliver value for customers.

We note that Ofgem intends to explore using the LI profile for transmission exit points to help inform an understanding of forecast transmission exit charges. While we recognise that DNOs can influence transmission exit point charges the triggers for reinforcement investment at these points are driven by the transmission system owner/operator. Therefore we believe that a LI profile for transmission exit points, defined by specific DNOs criteria, would not provide meaningful information regarding reinforcement investment need and future transmission exit charges.

93/09 Ch17 Q2*: Is our proposed process for determining whether a DNO has performed satisfactorily against its agreed DPCR5 outputs appropriate?*

The approach outlined in the Initial Proposals is suitable in determining how a DNO has performed against the suite of output measures. The DPCR5 settlement will provide DNOs with a suite of output measures to be delivered through the capital and operational expenditure allowances. As DPCR5 will be the first period where this level of output measures has been used it is appropriate that the impact of changes in outputs due to different circumstances is considered and understood before a DNOs performance is established.

During DPCR5 changes in the suite of output measures will be caused by:
- Improvements in definitions of outputs
- Updated information
- Emergence of new issues (e.g. asset defect or change in legislation)

- Variation between actual and forecast growth and deterioration
- DNO performance against outputs

It is vital that these impacts are understood and a DNOs overall performance is reviewed against the whole suite of outputs. The overall suite must be taken into account as under performance in one area may be driven by a significant change in another area which has required focus and investment.

93/09 Ch17 Q3: *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?*

If, based on the detailed information provided by a DNO to justify its position in relation to the forecast outputs, Ofgem can demonstrate that a DNO has under performed then it is appropriate that the DNO should face a penalty.

The degree of the penalty should be directly related to the degree of underperformance and the associated circumstances. The range of financial penalties outlined in the initial proposals provides Ofgem with appropriate scope to penalise under performance.

A possible approach would be to adjust the capital expenditure incentive-sharing factor, which would have applied under the IQI mechanism. However this would introduce uncertainty to the outcome of the IQI mechanism, which may be counter-productive.

On balance, we prefer an adjustment to allowed revenue for DPCR6, which would allow a more thorough assessment of the reasons for any apparent shortfall in outputs. The details of the mechanism should be set out in a Special Licence Condition, a draft of which should be made available at the time of the Final Proposals. We envisage that the approach detailed in Special Condition J7 of SP Transmission's Licence could be amended and developed to provide a formal basis for such an adjustment.

The Information Quality Incentive does not adequately deal with RPE uncertainty Incentive given the scale of risk that shareholders would still bear for commodity prices that are largely out with their control.

DNOs remain exposed to up to 41% of any necessary overspend (with the 59% funded ex post).

We have previously suggested (section 2.2) an indexation methodology or an ‘‘iDOK’’ mechanism. However, an alternative is that ***the IQI mechanism could be made fit to deal with RPE uncertainty by setting the incentive rate to 10% for RPE specific effects.***

93/09 Ch17 Q4*: *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?

Establishing whether a DNO has under or over spent against their allowance is part of the price review settlement process. However, consideration of this element in isolation should not determine the treatment of a DNO for under performance against the suite of output measures. The circumstances and reasons for a DNO's under performance against the suite of DPCR5 output measures should be established through the review process outlined in the initial proposals document. It is against these circumstances and reasons that Ofgem should determine whether a DNO should be penalised for its performance and the extent of that penalty.

An under spend of allowance with under performance against the suite of outputs may seem to indicate a DNO who has deferred investment at the expense of long-term stewardship. However the under spend and the under performance may be due to prolonged land issues associated with several large schemes which has delayed delivery to the next price review.

In the same way an overspend of allowance with under performance against the suite of outputs may seem to indicate a DNO who has strived to deliver the outputs but has suffered from particular asset issue or deterioration. However the overspend may be associated with inefficient investment in some asset areas which has resulted in under performance in other areas.

3.18 Innovation Funding Incentive (IFI)

93/09 Ch18 Q1: *Do you agree with our proposal to retain IFI?*

Yes – IFI will focus on technologies that are not directly linked to low carbon economies and to further collaborate with academia and industry on a true non-competitive basis.

93/09 Ch18 Q2: *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?*

We agree with this assumption as IFI tend to fund project that are in their early stages of development and Technical Readiness Levels of 1 to5 in collaboration with academia and other organisations. IFI also cover other aspects of asset managements that are not directly related to Carbon reductions but more to enhancing customer services and asset conditions.

3.19 - Equalising incentives and the information quality incentive

93/09 Ch19 Q1*: *Does the 85 per cent capitalisation of all costs within the equalised incentive provide an appropriate speed of money?

We believe that the %age capitalisation should be set somewhere between 80% and 85%. We estimate that around 80% gives DPCR4 neutrality, which is a reasonable allocation. However 85% would seem intuitively reasonable given that DNO's are capital-intensive businesses.

***93/09 Ch19 Q2*:** *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?*

Fine-tuning the IQI matrix at this stage will not help to incentivise accurate forecasting, as it effectively becomes an *ex post* adjustment.

There is no way of calibrating perceived risk-aversion and even its existence has not been established.

In the current economic climate it is not surprising that there are widely differing views about

- macro-economic developments, including
    - the depth, timing and speed of recovery from the recession
    - regional developments
    - exchange rate movements, and
    - relative price and cost changes
- future government policies
- environmental and climate change developments

Ofgem appear to give undue weight to their benchmark figure, which is implicitly based on just one of many potential outcomes. Allowance needs to be made for this genuine uncertainty, which means that Ofgem's underlying assumptions are extremely unlikely to be met.

We support a range for the incentive strength of [30% to 50%], which is closer to the average effective incentive strength for DPCR4.

***93/09 Ch19 Q3*:** *What approach should we adopt when setting the start to earn points of the IQI matrix?*

A DNO which spends in line with its forecasts is entitled to earn the full WACC, unless that level of expenditure would be demonstrably inefficient.
Any adjustments that are required to maintain incentive compatibility should be no more than necessary.

Steepening the incentive rate, as Ofgem are considering, would penalise DNOs whose forecasts are less than 5% above Ofgem's benchmark, which would take no account of current uncertainties and the substantial margins for error in Ofgem's benchmarking. We do not accept that Ofgem's benchmarking is accurate to within 5% for each DNO.

Given the current economic, environmental and political uncertainty, together with the limitations of Ofgem's benchmarking, it would be inappropriate to penalise DNO's whose forecasts are not materially above Ofgem's benchmark.

Furthermore, the disbenefits of underinvesting have been widely acknowledged by regulatory and competition authorities as being greater than the additional costs of marginal investments. Inappropriate deferral of expenditure would disadvantage future customers. Moreover, many developed countries including the USA, are deliberately encouraging investment in infrastructure, as a means of stimulating their economies.

IQI should be designed to encourage accurate forecasts, not necessarily low forecasts.

The Information Quality Incentive does not adequately deal with RPE uncertainty Incentive given the scale of risk that shareholders would still bear for commodity prices that are largely out with their control.

DNOs remain exposed to up to 41% of any necessary overspend (with the 59% funded ex post).

We have previously suggested (section 2.2) an indexation methodology or an ''iDOK'' mechanism. However, an alternative is that the IQI mechanism could be made fit to deal with RPE uncertainty by setting the incentive rate to 10% for RPE specific effects.

4.0 – ALLOWED REVENUE COST ASSESSMENT (94/09)

***94/09* Q1:** Have we taken an appropriate approach to assessing costs?

4.1 OPERATIONAL COSTS

Operational Costs: We are concerned about the robustness of work in this area and have found approximately £100m of errors or omissions relating to the treatment of vehicle & transport costs, fault costs, workforce renewal and specific SP Manweb costs that we expect to be addressed.

From the outset we have had concerns over both the methodology employed using disaggregated costs and activity drivers. We also have some concerns about the quality and robustness of Ofgems analysis given the errors and omission we have found so far.

The last two years of Ofgem cost reports have indicated that SP Distribution (SPD) appears to be one of the most efficient DNOs in terms of operating costs and yet the Initial Proposals would indicate otherwise, setting an allowance that will be substantially below SPD's forecast DPCR4 costs. This despite upward cost pressures due to an ageing asset base, rising risk profile and the need for a significant increase in maintenance to support investment.

Whilst Ofgem has provided significant amounts of data to support its efficiency comparisons, we are disappointed by the lack of a clear audit trail and coherent model structure that would provide companies with the necessary transparency to complete a validation, challenge and correction of Ofgem's work. As a result our review has therefore required, so far as is possible, a time consuming forensic investigation of the data provided.

Our review of this area of work has highlighted two key concerns. Firstly, that we do not accept the Ofgem models are fit for purpose; the work is not statistically robust as half of the regressions for disaggregated costs fail the model specification tests, indicating that one or more explanatory variables have been omitted and/or the functional form is inappropriate. Of the remaining four regressions, two have an R-squared of 0.4 or less. Furthermore the cost drivers are not fully independent of costs.

We believe the methodology used at DPCR4 for assessing comparative efficiency offers distinct advantages over that proposed for DPCR5: -

- The relationship between cost and driver is well fitted by a linear model, as demonstrated by the high R-squared, 0.93.
- The narrower range of efficiency scores is more plausible.
- There are no significant outliers, so analysis by simple least-squares regression is likely to be reasonably valid

- The top down cost driver is stable over time – in terms of efficiency, DNO's can only move significantly in the y (cost)-direction), whereas an activity-based driver also allows efficiency positioning by manipulation of the driver (movement in x-direction).
- The top down cost driver naturally compensates for any cross-boundary allocation issues that the disaggregated cost model doesn't.
- In its proposed methodology Ofgem has "cherry-picked" efficient benchmarks for each of the activity drivers thereby creating a theoretical hybrid company that no DNO could ever expect to achieve.

There still remains an unexplainable disparity between the cost assessment work performed to date and the results obtained under a DPCR4 approach.

Secondly, we have found approximately £100m, of errors or omissions. These include costs relating to the treatment of vehicle & transport, faults, workforce renewal and specific SP Manweb costs.

We also note that at the moment Ofgem has not taken account of any increased costs associated with the introduction of new obligations such as the provision of additional information to Renewable Generators or complex connections reporting for example.

The practical consequences of your analysis, which changes our forecast increase of £59m in operating costs into a reduction of £87m against our DPCR4 forecast (a swing of £146m) implies that in areas such as Inspections and Maintenance we will be unable to meet mandatory requirements and manage our business at an acceptable level of risk. The outcome is particularly onerous in respect of indirect costs. We cannot understand how SPD, as an upper quartile performer over the last 2 years, and seeking around the lowest increase in indirects in DPCR5, still faces a double-digit percentage cut. Indeed two other companies also performing better than DPCR4 allowance have suffered, like us, the largest reductions compared to DPCR4 expenditure levels.

4.2 CAPITAL EXPENDITURE ALLOWANCES

Capital Expenditure Allowances: In contrast to operational costs the modelling in this area has been relatively well communicated and transparent.

However, there are still a few areas that give us concern, in particular in relation to condition-based asset replacement. We continue to work with your teams on these areas. We are also conscious that at the time of writing approximately £150m of capital expenditure had not been reviewed by Ofgem and we await your September update paper on these items.

Following SPEN's review of the initial proposals documents we have a number of questions regarding how the capital allowances for SPD and SPM have been established.

We have submitted detailed evidence and arguments against a number of reductions to our plans to the Ofgem Capital Expenditure team where our plans have been reduced inappropriately.

Ofgem should correct these errors prior to the Final Proposals.

4.3 MECHANISMS FOR DEALING WITH UNCERTAINTY

94/09 Q2: *What mechanism should be used to fund high value projects?*

Out of the 3 options presented, we would prefer the first option which provides an ex-ante allowance, with an ex post review.

Our second preference is partial upfront funding, with a mechanism to flex the investment (and revenues) (similar to the Transmission Deep Reinforcement methodology) for specified schemes.

94/09 Q3: *What assumptions do you think we should use for real price effects and ongoing efficiencies for DNOs over the 2010-15 period?*

Inflation/Real Price Effects: We anticipate that Revenues will be affected by negative deflation in the first year of the price control, however the stark reality is that utilities continue to be adversely impacted by prices for labour, materials and contractors. This will adversely impact companies' ability to finance their activities.

It is unreasonable to expect the DNOs to be able to keep costs at or below inflation in this environment. In particular, we believe that Ofgem has understated the labour cost pressures that DNOs, their contractors and manufacturers will face during the next six years by failing to recognise any differential wage inflation for skilled infrastructure specialists and by assuming that average earnings return to an inexplicably low rate of growth when the recovery from the current period of recession is completed. It is also important to note that CEPA's position on this area, and upon whose work Ofgem relied, appears to have changed dramatically. We would refer Ofgem to their latest report published this month.

The risk companies face in this area will be further compounded by the proposals that they are being asked to sign up to in terms of output measures. We support output measures and have supported Ofgem throughout this process in this area but if companies are asked to bear the risk of both outputs and price effects this dramatically increases risk and reduces expected returns. Nor do we accept that this issue is covered by the Information Quality Incentive mechanism given the scale of risk that shareholders would still bear for commodity prices that are largely out with their control.

We have previously proposed a form of indexation related to a basket of indicators for RPEs, which would operate beyond an appropriate threshold. We envisaged such a mechanism would operate symmetrically and protect both consumers and companies. Alternatively an “iDOK” type mechanism such as is in place for the Water companies could provide a solution.

In an update[11] for the ENA, First Economics summarise recent data on wage inflation:

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

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

Note: the data in the table has been aligned to give a consistent picture at a specific point in time. There are later figures for some of these indices, but we do not show them in the table so as to ensure a like-for-like comparison.

First Economics comment:
“The table shows gives a clear sense of a differential in DNO wage inflation as at the latest date for which figures for a full set of figures are available. It is also worth noting that the BEAMA index has continued to grow at a constant level since the cut-off date for the table: the provisional September 2009 release has annual wage inflation for electrical engineers running at 3.7%, which we suspect will turn out to represent a widening of the differential to average earnings growth when data from the ONS series becomes available.

[11] First Economics (2009) “Forecasting Wage Inflation”, September

First Economics conclude:
“The analysis in this paper has highlighted what we think are two errors in Ofgem’s initial proposals: the assumption that wage inflation affecting DNO costs will match economy-wide average earnings growth; and the assumption that average annual earnings growth in steady state is 3.7%.

Our recommendations are that Ofgem ought to:

- allow a premium to average earnings growth for workers with scarce infrastructure skills, consistent with the premia that are apparent in table 1 and consistent with the logically better position that such workers find themselves in relative to the average employee during a period of recession; and
- ensure that its forecasts for average earnings growth trend back to 4.25%.”

General wage inflation

	Average earnings growth
pre-2008	4.25%
2008/09	3.5%
2009/10	2.5%
2010/11	3%
2011/12 and after	4.25%

94/09 Q4*: Do you agree with our proposed methods for handling uncertainty?*

We agree that the DPCR4 drivers for units distributed and customer numbers should be removed.

We welcome the re-opener mechanism for “general reinforcement expenditure and high cost connections capex involving shared assets”.

- We feel this is an effective mechanism
- It is important to separately track both of these activities and be able to trigger this mechanism for either.

- See Q5 below for comments on the volume flex for connections

See Q6 below for comments on the re-openers for general reinforcement / high costs shared connections

We are supportive in principle with:

- treating sole use connections as an excluded service
- volume drivers for high-volume low-cost connections
- a combined re-opener for general reinforcement and high-cost connections capex involving shared assets
- retaining re-opener for TMA costs and the equivalent in Scotland

The Information Quality Incentive does not adequately deal with RPE uncertainty Incentive given the scale of risk that shareholders would still bear for commodity prices that are largely out with their control.

DNOs remain exposed to up to 41% of any necessary overspend (with the 59% funded ex post).

We have previously suggested (section 2.2) an indexation methodology or an ''iDOK'' mechanism. However, an alternative is that ***the IQI mechanism could be made fit to deal with RPE uncertainty by setting the incentive rate to 10% for RPE specific effects.***

94/09 Q5: *Are our proposals for volume drivers on low-cost connections involving shared assets proportionate, i.e. is the mechanism necessary?*

We have reservations over the need for this mechanism, as we feel the complexity and uncertainties in this area will likely mean that the mechanism may end up dramatically moving from the original position, and being inappropriate due to:

1. Actual unit costs which materialize in DPCR5 may vary substantially dependant on the mix of connections which actually materialize in the DNO arena e.g. for LV with HV : the cost per connection for a 200 connections on a housing development site with 1 substation will be radically different from a 3km HV OHL to feed 1 LV rural customer.
    - This will change due to competition (IDNOs may take the high volume market)
    - It will also flex due to UK economic recovery
2. Volume of Connections may change dramatically dependant on the market share that materialises due to different mixes of IDNO / ICP and licensed connections.

We would suggest that the detailed and complex process of trying to refine and develop unit costs / volume measures in this area is inappropriate;

particularly given the materiality of this investment. As an alternative approach we would suggest that <u>all shared investment</u> for connections be included in the Load Related Re-opener approach, not just the 'high cost – low volume' connections.

***94/09* Q6:** *What is an appropriate materiality threshold for the operation of our proposed load related expenditure reopener?*

We would tend to agree that 20% threshold for a re-opener is a reasonable approach, and would confirm that we consider that it should be triggered by <u>either</u> shared connection costs (both low value & high value shared connections costs as above) <u>or</u> general reinforcement. We support that the mechanism can be triggered by either actual cost increases or forecast cost increases. For general reinforcement schemes we recognise that it is important that the DNO can demonstrate a 'net' variation in load indices, or other reinforcement drivers (e.g. P2/6) that drives a change.

We recognize that OFGEM have reservations over load growth from some DNOs, and wish to put in place a clawback / reconciliation to address load growth uncertainties. Within SPEN our submission recognized a generally flat load profile but with investment requirements to address particular network hotspots. These types of investment, to deal with hotspots, will still be required even if network wide load growth deviates from our forecast. A mechanistic approach for clawback may not be appropriate, as efficient DNO delivery will have had to manage uncertainties such as

- How the load indices have changed across the network
- Whether the DNO has invested to manage a risk which was credible, but failed to materialize due to economic circumstances
- Unexpected network requirements which require investment to address compliance with P2/6 or n-2 schemes
- Local / National government economic or low carbon initiatives

A DNO should be encouraged to innovate, therefore clawback should be limited to that out with the 20% band, with the DNO being able to keep any gains made within that band.

SECTION 5 – ALLOWED REVENUES AND FINANCIAL ISSUES (95/09)

5.1 COST OF CAPITAL

95/09 Ch1 Q1*: Do respondents think that PwC have identified an appropriate range for setting the cost of capital?*

SEE RESPONSE IN SECTION 2.3

95/09 Ch1 Q2*: How should we balance our standard long-term view of the cost of capital with current indicators in the capital markets?*

The current cost of equity is higher than the historic average. The current cost of equity should be weighted at least 50%, as the effects of the credit crunch and recession are expected to persist well into the DPCR5 period.

The current cost of debt is also higher than the historic average. The weighting on the current cost of debt should reflect the proportion of total debt that has to be raised or re-financed during DPCR5. This is estimated to be at least 30%.

SEE ALSO RESPONSE IN SECTION 2.3

95/09 Ch1 Q3: *Which, if any, of the alternative methods of dealing with variability in the cost of debt should we adopt?*

Our preference is for an appropriate *ex ante* allowance. We do not see the need for a debt trigger mechanism provided that the cost of debt for DPCR5 is set at an adequate level. We agree with the Competition Commission's view that companies are in a better position than most customers to manage interest rate risk.

Furthermore, setting an *ex ante* allowance maintains a strong incentive on companies to optimise their financing costs.

SEE ALSO RESPONSE IN SECTION 2.3.1

95/09 Ch1 Q4: *What are the pros and cons of the mechanistic debt trigger as suggested by PwC?*

A debt-trigger would have poor incentive properties, as it may encourage companies to track the index designated, rather than reduce the overall cost of debt through effective treasury management.

In any case, constructing an accurate index of the cost of debt would be difficult. Analysis undertaken for us by CEPA shows that candidate indices can vary by several tens of basis points and many potential components are only available through proprietary data services, which would result in a lack of transparency.

CEPA's analysis also highlights that the revenue adjustment mechanism would be potentially complicated if applied frequently. Closely tracking the cost of debt would lead to an increase in the volatility of use of system charges.

SEE ALSO RESPONSE IN SECTION 2.3.1

5.2 RAV ADDITIONS

95/09 Ch2 Q1: *Do you agree with the draft rules for computing RAV additions and will they reduce or eliminate boundary issues at DPCR5. If not how should they be amended?*

We are comfortable in principle with the rules for computing RAV additions and believe that they will reduce boundary issues. We would trust that this will allow Ofgem to consider reducing the extent of subsequent regulatory cost reporting required through the annual RRP pack in certain areas.

95/09 Ch2 Q2: *In what circumstances would you consider it appropriate to have DNO-specific RAV additions percentages?*

It is conceivable that RAV additions percentages could be used as a tool to address financeability issues or DNO specific capitalisation policies where for example the latter arise from structural differences. However such an approach may compromise transparency and increase complexity for stakeholders.

5.3 EXCLUDED SERVICES

95/09 Ch3 Q1: *Do you agree with our proposal to bring the distribution of units to new EHV premises, provision of charging statements and reactive energy transportation within the scope of the main charge restriction conditions (see paras 3.9 to 3.19 above)?*

This is reasonable provided any costs associated with new EHV premises, provision of charging statements and reactive energy transportation are included within the DPCR5 RAV and cost allowances. We agree that there should be a re-opener provision to cater for the situation where there is an exceptionally large/unexpected EHV development. Other EHV developments would be recognised as part of the DPCR5 costs/RAV true up during the DPCR6 process.

95/09 Ch3 Q2: *Do you agree that revenue protection services should be exempt from a RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party? (see paras 3.20 to 3.22 below)*

We agree that revenue protection services should be exempt from a RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party (which could be a related party).

We wish to confirm that no costs associated with revenue protection are included in our FBPQ costs forecasts therefore it is incorrect to deduct our forecast revenues for this service from DPCR5 price control allowed expenditure and hence from allowed revenue.

95/09 Ch3 Q3: *Do you agree with the proposed RAV adjustments for top up and standby, other system charges and metering excluded services where reported revenues (costs in the case of metering) exceed forecasts? (see paras 3.23 to 3.32 below)*

Top up and standby and other system charges: where reported revenues are different to forecast revenues an adjustment (both positive and negative) should be made to both fast pot and slow pot categories pro rata to the fast pot/slow pot split in the final proposals. It is not correct to assume that all the incremental costs all relate to the RAV.

Metering excluded services: For the reasons stated in our response to question 5 below metering activity (both legacy metering and metering excluded services) is not part of the Distribution Price Control Review. Consequently, no adjustment should be made to totex costs or RAV; and even if metering excluded services were part of the price review no adjustment should be made because any additional costs associated with extra activity will be additional costs to the business as opposed to resources transferred from DUoS funded activities.

***95/09 Ch3 Q4*:** *Do you agree with our proposals with regard to diversion works in DPCR5?*

Diversion works are contestable where physically and electrically separate from DNOs' network, and as a consequence are delivered in line with the industry leading levels of competition in connection in the SPEN areas. We do not accept that in majority of cases the DNO must carry these out.

These are not 'modified connections' and should not be treated as such. It is not reasonable to disallow margins.

***95/09 Ch3 Q5*:** Do you agree with our proposals regarding metering excluded services?

We do not agree with the proposals regarding metering excluded services. Forecast costs (or forecast revenues as a proxy for costs) relating to metering excluded services must not be deducted from DPCR5 price control allowed expenditure and hence from allowed revenue. Metering activity (both legacy metering and excluded services metering) is not part of the Distribution Price Control Review. DPCR4 excluded all activity relating to metering; no metering activity is reported as part of the costs in the DPCR4 RRP tables; and, consistent with this, no costs for MAP and MOP have been included in our FBPQ costs submission anywhere (as noted in our response to FI_6045). The fundamental example of this is the RAV calculations in the DPCR4 RRP tables – these do not include metering activity relating to either legacy metering or excluded services metering because the RAV as established in DPCR4 purely reflects networks costs excluding all metering activity. We believe the approach in DPCR4 should be maintained in DPCR5.

Consequently and as noted above in our response to question 3 no adjustment should be made to totex costs or RAV; and even if metering excluded services were part of the price review no adjustment should be made because any additional costs associated with extra activity will be additional costs to the business as opposed to resources transferred from DUoS funded activities.

5.4 TREATMENT OF TAXATION

***95/09 Ch4 Q1*:** *Do you agree with our position on the tax methodology?*

We agree with the position on the tax methodology subject to satisfactory resolution of the principal concerns identified in paragraph 4.1 of the Initial Proposals – Allowed Revenues and Financial issues (Ref 95/09). We have the following comments on these principal concerns:

5.4.1 Appropriate opening capital allowance pools

Using the DNOs own forecasts of the opening CA pools at 1 April 2010 makes no recognition of the fact that the tax relief for capital expenditure is given over a number of years and will therefore fall into more than one price control review period and seems at odds with Ofgem's intention to not give tax relief twice for any item of expenditure not to deny relief for any expenditure. It is therefore flawed to consider each price control review in isolation.

In our response to the DPCR5 Methodology & Initial Results Paper (Doc Ref 47/09) we set out in detail why we consider that the opening tax pools brought forward from DPCR4 should be based on the methodology adopted in the DPCR4 model. That remains our position and we refer you to that response.

In paragraph 4.4 of the Initial Proposals – Allowed Revenues and Financial Issues ref 95/09 it is acknowledged that "Such differences arise as the DPCR4 methodology did not follow the statutory treatment of allowing expenditure as deductible for tax but instead followed our own *(Ofgem's)* modelling methodology." That is correct. However in preparing our statutory accounts and submitted corporation tax returns we are not allowed to follow Ofgem's regulatory modelling methodology, instead we are obliged to abide by existing accounting standards and tax law which includes legislation and case law. This means that some items of expenditure that Ofgem treated as operating costs (100% relief) for the purposes of calculating the tax allowance are in fact capital for tax as a point of law. If the opening tax pools for calculating the tax allowance in DPCR5 are based on the submitted corporation tax returns, effectively a tax deduction will be given twice for the same item of expenditure. This is double counting of capital allowances not a timing difference.

Paragraph 4.6 goes on to say "We do not seek to maintain shadow regulatory *(tax)* data …". Our recommendation does not require this. To overcome the issue relating to the opening capital allowances pools at 1 April 2010 and avoid the tax deduction being given twice for the same item of expenditure we recommend a one-off revenue correction in DPCR5 to reflect the tax impact of the difference between the capital allowances pools on the DPCR4 basis at 1 April 2010 and the opening tax pools at the same date based on submitted corporation tax returns. This would then enable the opening capital allowances pools to be based on submitted corporation tax returns. This approach is cleaner and has the advantage of completing the transition to the new basis of tax modelling for expenditure in DPCR5 based on applying the tax definitions of allowable expenditure and DNOs' own capitalisation policies.

We are pleased that tax modelling for expenditure in DPCR5 is now based on applying the tax definitions of allowable expenditure and DNOs' own capitalisation policies.

To overcome the issue relating to the opening capital allowances pools at 1 April 2010 and avoid the tax deduction being given twice for the same item of expenditure there are 2 options for the appropriate opening capital allowances pools:

1. To calculate the capital allowances pools on the DPCR4 basis; this would mean maintaining shadow regulatory tax data which would be clumsy and become messy in future price controls as different approaches are used to calculate capital allowances pool additions;
2. To make an adjustment in DPCR5 to reflect the tax impact of the difference between the capital allowances pools on the DPCR4 basis at 1 April 2010 and the opening tax pools at the same date based on submitted corporation tax returns. This would then enable the opening capital allowances pools to be based on submitted corporation tax returns. This approach is cleaner and has the advantage of completing the transition to the new basis of tax modelling for expenditure in DPCR5 based on applying the tax definitions of allowable expenditure and DNOs' own capitalisation policies.

5.4.2 Capitalised pension costs

SP Distribution and SP Manweb capitalise a portion of pension contributions and obtain a computational deduction in the form of capital allowances. This diverges from the current DPCR5 modelling of pension costs which assumes a 100 per cent deduction of pension costs for tax purposes.

Paragraph 4.11 asserts that it is a function of the group structure which has meant that these two companies do not get a 100% deduction for tax purposes and hence suffer a detrimental effect in the current financial modelling. The fact is that pension costs, like other employment costs, follow the cost allocation rules associated with the activity performed by the employee. If the employee is engaged in a capital activity then the associated pension costs also get capitalised; this is consistent with recommended accounting practice. Likewise these capitalised pension costs are treated as capitalised for tax purposes. This practice has been accepted by HMRC.

Paragraph 4.10 infers that SP Distribution and SP Manweb have not dealt with this issue as effectively as other DNOs. We would be interested in debating the correct treatment with Ofgem and HMRC to see if HMRC would be willing to accept a change in treatment as you propose – we suggest that the tax authorities may not be willing to accept a practice which has the effect of reducing corporation tax paid.

We urge Ofgem to reconsider their modelling of tax in respect of pension costs for SP Distribution and SP Manweb.

5.4.3 Definition of legislative changes

In respect of the tax trigger and the definition of legislative changes, we believe that provided any assessment of a tax impact meets the five key criteria set out in paragraph 4.13 then the scope of the mechanism should include HMRC interpretation, case law and changes arising from accounting standards. This would ensure that the potentially sizeable tax impact of IFRIC18 would be included.

5.4.4 TAX TRIGGER MECHANISM

95/09 Ch4 Q2: *Do you agree with the proposal to establish a tax trigger mechanism and that we have established an appropriate balance between incentivising DNOs to manage their tax risks and sharing the risks of rewards with consumers?*

We agree with the proposal to establish a trigger mechanism and welcome the decision that any tax trigger adjustment will be on the whole amount not just the excess over the trigger.

Tax trigger thresholds - in respect of the trigger point our calculations based on the average 5 year tax allowances and the average 5 year base revenue in the Initial proposals suggest that on average a 2% change in the corporation tax rate would be needed to breach the 0.5% trigger point (the range is 1.32% to 3.25%). Based on 2010/11 Initial Proposals revenues a +/- 2% change in corporation tax in 2010/11 would expose DNOs/consumers respectively to over £100m over the 5 years of DPCR5. We don't believe that this level of exposure was the intention of the trigger mechanism and request that the trigger point be reconsidered. We believe that 0.25% would strike a reasonable balance between materiality of impact and practicality of application.

Cost of capital – we do not accept that a move to a symmetrical adjustment in respect of changes in relevant tax legislation results in a reduction to the cost of capital. The mechanism simply seeks to deal with a newly emergent risk since DPCR4.

5.4.5 Determination of opening capital allowances pool balances

SP Distribution and SP Manweb capitalise a portion of pension contributions and obtain a computational deduction in the form of capital allowances. This diverges from the DPCR4 modelling of pension costs that assumed a 100 per cent deduction of pension costs for tax purposes. Therefore, the opening tax pools would need to be reduced to eliminate any remaining balances relating to pension costs treated as 100% deduction for tax purposes in DPCR4; otherwise a tax deduction will be given twice for the same item of expenditure. We propose that this adjustment should be back to 1 April 2005 when tax allowances were first introduced as part of DPCR4.

5.5 ALLOWED REVENUE PROFILING

***95/09 Ch6 Q2*:** How do respondents think we should profile allowed revenues over the 2010-15 period?

Revenue profiling ideally should be smoothed in accordance with the cash flow requirements of the Business. In modelling revenues we urge Ofgem to underpin those models with strong tests for achievement of investment grade criteria (consistent with A-) and to make any appropriate adjustments to ensure companies meet those criteria.