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Dear Rachel,

Electricity Distribution Price Control Review Initial Proposals

Scottish and Southern Energy welcomes the opportunity to respond to Ofgem's Initial Proposals for the current distribution price control review (DPCR5). Our detailed response, including responses to Ofgem's questions, is attached.

As the proposals stand, we do not believe they provide the necessary costs to allow us to operate our two licensed distribution networks in the manner that has enabled us to be at the efficiency frontier at every other price review. Indeed, for Scottish Hydro Electric Power Distribution (SHEPD) we are concerned that the proposed reductions in our operating costs will have a serious impact upon our ability to comply with statutory and licence obligations.

In our June response to Ofgem's methodology and initial results paper, we were very supportive of Ofgem's approach to benchmarking. The relative efficiencies and rankings of the DNOs were consistent regardless of the cost drivers and methodologies used. However, the proposal to set allowances on separate benchmarks for network operating costs (NOCs) and indirect costs has resulted in serious inconsistencies, e.g. SHEPD at the frontier for NOCs, second most efficient overall, but ninth when looking at indirect costs in isolation. This is clearly wrong. As such, we very strongly believe that the only practical option is to return to using a combined NOC and indirect cost efficiency score to set baseline allowances.

We also disagree with Ofgem's proposal to move away from its single efficiency line. There is no reasonable logic for this: it rewards inefficient DNOs by factoring in out-performance and fails to adequately reward frontier companies. We believe Ofgem needs to revert back to

a single efficiency line; if not the average, somewhere between the average and the upper quartile.

We have written to Ofgem separately on both of these points and have included our concerns in our detailed response.

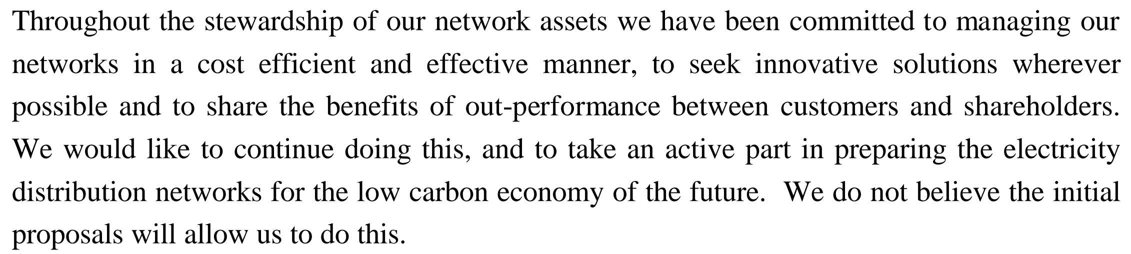
In June, we were also supportive of Ofgem's efforts to determine the DNOs' capital expenditure requirements and the introduction of output measures. However, this has since taken a backward step; we do not believe that the proposed reductions in our capital expenditure programme will allow us to meet the output measures we were prepared to commit to in our FBPQ submissions.

We firmly believe that our approach to asset replacement and general reinforcement is robust and believe that we have presented a strong, evidence based case to back up the volumes we require for DPCR5. Again, we have written separately identifying a number of areas of concern with Ofgem's approach to setting capital allowances and have reiterated these in our detailed response.

On the subject of output measures, we are disappointed with the direction this initiative has taken. In June, we had understood that Ofgem was taking a proportionate and pragmatic approach to developing bespoke output measures for DNOs. Whilst we have been supportive of the move to common, high level measures, we do have serious concerns that this is developing into a suite of measures at a level of granularity and detail that is symptomatic of micro-management and will, in our view, result in a 'one-size-fits-all' approach. We believe that this will stifle innovation and drive all DNOs to the average rather than the frontier of performance.

The proposed cuts in our operating and capital allowances, the introduction of mechanistic output measures, along with Ofgem's micro-management of our capital expenditure programmes (e.g. requiring that we fit open wire rather than BLX), combine to seriously challenge the concept of incentive regulation. Indeed, the opportunity to outperform across a number of incentive mechanisms has been consciously reduced: the Information Quality Incentive (IQI), potentially the distribution losses incentive and the incentive to connect distributed generation.

In such circumstances, it appears to us that the optimum DNO strategy is to spend the operating and capital allowances, no more, no less. Under this regulatory framework, there is no incentive to seek to outperform the settlement. However, the 'decision' to equalise capex and opex incentives introduces another driver. We believe this decision will drive the DNOs to bring all expenditure to a statutory minimum; no quality of service improvement, no losses improvement, no carbon initiatives and clearly no incentive to innovate. In our view the Initial Proposals signal the end of RPI-X incentive regulation.



Throughout the stewardship of our network assets we have been committed to managing our networks in a cost efficient and effective manner, to seek innovative solutions wherever possible and to share the benefits of out-performance between customers and shareholders. We would like to continue doing this, and to take an active part in preparing the electricity distribution networks for the low carbon economy of the future. We do not believe the initial proposals will allow us to do this.

Yours sincerely,

Malcolm J. Burns
Regulation Manager

92/09

Key Messages:-

- **Whilst we believe Ofgem has identified the right behaviours, we do not believe the Initial Proposals provide sufficient revenue or incentive to drive these behaviours. There is therefore a risk that DPCR5 could be a missed opportunity.**
- **We have been supportive of the allowance-setting process to date. However, the proposed changes to both Ofgem's benchmarking analysis and unit cost assessment, have resulted in serious inconsistencies and a settlement package that is unacceptable to us.**
- **We believe there is increased risk going into DPCR5: fundamental changes to the regulatory framework; less scope for out-performance; increased economic uncertainty; etc. We therefore firmly oppose efforts to talk down the cost of capital and believe PwC's proposed range to be far from acceptable.**

CHAPTER 2: BEHAVIOURS, INCENTIVES, FUNDS AND OBLIGATIONS

1. Have we introduced a set of measures that can be understood by customers and other stakeholders?

We believe the framework being proposed in DPCR5 is more complex than we have seen in previous price controls. This is largely driven by the fundamental shift being proposed in the way that capital and operational expenditure is regarded and subsequently treated. This change in itself will require considerable effort on the part of all stakeholders, including customers, shareholders and analysts, if they are to understand the implications of the settlement.

In addition, we believe this fundamental shift will make it very difficult for stakeholders, and indeed the DNOs and Ofgem, to have any real certainty that the incentive mechanisms will drive the behaviours intended in terms of the long-term health of the network and wider Government policy. Indeed, given the level of change being proposed, we believe there is a high risk of unintended consequences during the period.

2. Are we aiming to encourage the behaviour you consider appropriate for DNOs in the 2010 to 2015 period?

We believe Ofgem has identified the right behaviours through its core themes, but are concerned that the proposed mechanisms are not sufficient to drive these behaviours. In order to bring about the substantial level of change that is required to get the distribution network businesses to where they need to be by the end of DPCR5, we believe strong incentives are needed, with opportunity for both reward and penalty.

With regard to the environment, we are very supportive of the work that Ofgem has done to date in terms of designing the Low Carbon Network (LCN) fund, and the considerable level of funds that have been made available to pay for these innovative solutions. Notwithstanding these positives, we believe more work is needed between now and Final Proposals to ensure that this mechanism offers a real incentive to trial innovative solutions.

There are considerable risks in pursuing innovative alternatives over conventional, well-tested approaches. Under the current proposal, DNOs will recover 90% of their costs. We accept that there is further potential benefit through the *ex post* discretionary award and wider roll-out, should a project prove successful. However, this additional revenue cannot be banked upon at the time of making the business decision as to whether to pursue an innovative alternative. We therefore suggest that Ofgem considers fully capitalising any LCN spend and attributing a higher rate of return to that spend to act as an upfront incentive.

We also believe Ofgem has taken a backward step in incentivising the connection of DG by reducing the absolute incentive rate. We are surprised by this move at a time when significant DG is required to meet the Government's carbon agenda.

On customers, we believe positive steps are being taken with regards to gauging customer satisfaction. We believe the broader measure will target the DNOs' efforts to improve their service levels, resulting in real benefits to customers. However, we are concerned that efforts being made elsewhere in relation to the provision of information to DG developers are less well thought through. The Initial Proposals do not align with the feedback we received from our stakeholders in terms of their needs and wants in this area.

In terms of network investment, Ofgem has recognised that a behavioural change is needed to drive more innovative thinking and network solutions. However, very early in the process, it committed itself to an equalised incentive approach, which, in our view, raises many more issues than it serves to address, and cuts directly across the formal RPI-X @ 20 review. What is more, we do not believe that the equalisation of incentives will result in more efficient investment. Instead, we believe it will drive a very short-term approach, with DNOs seeking to identify the lowest cost solutions across the five-year price control period, which will not necessarily result in the lowest overall cost to the consumer. In short, we still consider that Ofgem's proposals penalise DNOs for investing in the system once the price control is set. We believe Ofgem should be concerned that one of the most consistently efficient DNO groups is expressing serious concern over the proposals to equalise incentives and whether it will indeed drive the behaviour that Ofgem is aiming for. In addition, we believe this is wholly inconsistent with the measures being taken elsewhere to drive more innovation.

3. Are the proposed mechanisms likely to be successful?

The Initial Proposals are still light on detail in terms of the various incentive mechanisms. Further work is still clearly needed, particularly in terms of the broader measure of customer satisfaction and the losses incentive. However, as stated in our response to Q2 above, we are concerned that the proposed mechanisms will not be successful due to their poor incentive properties.

In terms of immediate feedback on the changes to the Information Quality Incentive (IQI), we have certainly seen a reduction in the strength of this incentive as proposed to date. We do not believe that it has suitably differentiated between those DNOs that have submitted robust and credible forecasts versus those that have pitched high, and this will undoubtedly be reflected in future submissions unless corrective steps are taken now.

We believe there are two steps that Ofgem could take to sharpen this incentive and to ensure that accurate forecasting is suitably recognised:

(i) Ofgem could apply the current matrix on an asymmetric basis. At present, DNOs positioning themselves at the left hand side of the matrix are as equally exposed to underperformance as they are to out-performance. Likewise, at the far right hand side of the matrix, whilst the DNOs have limited upside available, they are equally protected from any downside risk. By skewing the matrix so that those DNOs providing the most accurate forecasts are allowed to retain, say, 50% of any out-performance, but face a lower exposure on the downside, for example 30%, whilst DNOs at the other end of the matrix face the reverse incentive strengths, we believe this addresses our current concern and restores the mechanism's incentive properties;

(ii) Secondly, Ofgem could link forecasting accuracy to output measures. There is logic in applying a lighter-touch approach to output measures for those DNOs that have submitted robust and accurate forecasts.

We believe both of these steps could be implemented ahead of Final Proposals and to more effect than the alternative matrix proposed in the Initial Proposals.

CHAPTER 3: PROPOSED ALLOWED REVENUES

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

We have been generally supportive of the allowance setting process to date. However, this latest iteration, as put forward in the Initial Proposals, has raised some serious concerns for us, both in terms of the benchmarking analysis and Ofgem's approach to unit costs for network investment. It is essential that these concerns are addressed. As the proposals currently stand, they are unacceptable to us.

The proposal to set allowances on a disaggregated basis has disadvantaged DNOs that have a strategy of insourcing. It is clear that despite efforts under the RRP process, differences still remain in the way that costs are being reported, particularly between direct and indirect costs. Since we have a strategy to insource, this increases our indirects relative to others. In addition, we believe there are DNOs that have reported indirect costs within load and non-load capex. Again, we have recorded these costs within indirect costs, as required by the RRP rules. By trying to isolate indirect costs, Ofgem's methodology clearly and unfairly disadvantages us and needs to be resolved ahead of Final Proposals.

Moreover, Ofgem's proposal to disaggregate operating costs into network operating costs and indirects for the purposes of its regression work and to set baseline allowances has resulted in inconsistent and perverse results. In all previous regressions, both during this review and previous reviews, Ofgem has focused on methods that have brought about consistent results and taken comfort from its ability to recreate the same rankings regardless of parameters / drivers used. This is not the case for Ofgem's latest approach. At an aggregated level, SHEPD has consistently been ranked the frontier or second best performing DNO. However, by moving to a disaggregated basis, this consistency is lost and SHEPD's revised ranking is first and ninth. This is demonstrative of boundary issues in the treatment of costs and should not be the basis on which allowances are set. This approach deducts £34 m from SHEPD's DPCR5 forecast, despite being ranked second overall.

As well as moving away from its consistent approach to regressions, Ofgem has also moved away from its historic approach to adopt a single efficiency line. We fundamentally disagree with this approach. This rewards inefficient DNOs by factoring in out-performance and fails to adequately reward frontier companies. We believe Ofgem should adopt a consistent approach and bring all DNOs for all operating cost categories to the average efficiency line. Whilst intellectually correct, we recognise that this may not be achievable in one step. As a minimum, we therefore propose that Ofgem establishes an intermediate point between the upper quartile and average performance, and that all DNOs are brought to that line.

One further key concern in relation to the operating cost element of our allowance is the assumed relationship between capex and indirects. Due to our profiling of capex over DPCR4, this assumption has resulted in a perverse and significant reduction in SEPD's indirect allowance. We believe this is easily addressed by either applying this relationship only in the event of capex increases or excluding larger capex schemes from this mechanism.

On network investment costs, we cannot accept the reductions proposed by Ofgem in terms of our unit costs. The volumes, which Ofgem has accepted, are not achievable at these revised unit costs. Nor are our currently proposed output measures. More

worryingly, some of the reductions that Ofgem has applied, imply that Ofgem is, in setting our allowances, dictating how we should invest in our network. This is clearly unacceptable.

We have written separately to Ofgem on each of these key points and others. We have welcomed Ofgem's engagement on these points to date and hope to see the resolution of these issues in our October update letter.

2. **What assumptions do you think we should use for real price effects on DNOs over the 2010 to 2015 period?**

   As part of the process, we have previously submitted to Ofgem our view on real price effects (RPEs), based upon the work carried out by First Economics. At that time, we suggested that DNOs should be allowed their forecast increases in input prices, but with a trigger mechanism to accommodate the ongoing uncertainty. We continue to believe this is appropriate.

3. **What are your views on PwC's range for WACC?**

   We consider the PWC range untenable. We have provided our full comment in response to Chapter 1 of 95/09. However, in summary, we have worked extensively with NERA and other DNOs to reach a view on an appropriate cost of capital and we agree with the results of this work. A post-tax real cost of capital between 4.6% and 5.4% is consistent with our own view that the frontier DNO should be able to earn at least 5.5% post-tax real (including out-performance).

   Furthermore, we are very concerned by Ofgem's suggestion that *"the "baseline" rate of return of most companies will be below the assumed rate of return in WACC"*. The cost of capital is the return required by investors. If there is insufficient allowance made for these costs, investors will not commit their capital to the sector.

4. **Do you think we need a mechanism to address cost of debt uncertainty?**

   No. We believe Ofgem should retain the current approach in relation to setting the cost of debt, i.e. it should be set as part of the price control review for the whole of the price control period. We believe any attempt to introduce a more mechanistic approach would be both complex and risk creating both unintended and disruptive consequences. These concerns are expanded on in our response to 95/09.

5. **What are your views on the debt trigger mechanism?**

   We remain strongly against any proposal to introduce either debt indexation or debt triggers. This was assessed during GDPCR and dismissed as overly complicated and impractical. We strongly believe that radical changes to setting the cost of capital are inappropriate for DPCR5, particularly if industry and the markets are to consider this price review as the fifth in a consistent process.

CHAPTER 4: RISKS AND REWARDS

1. **Do you agree with our approach to calibrating the price control settlement?**
   Whilst not opposed to Ofgem's return on regulatory equity (RoRE) construct *per se*, our preference is to look at return on capital employed. More fundamentally, we are concerned at the way in which Ofgem has applied the RoRE test. In particular, we do not consider that the levels of out-performance suggested by Ofgem are achievable.

2. **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?**
   WACC is the return *required* by investors. Efficient DNOs should be capable of outperforming this level. In our view, an efficient DNO should be able to earn in excess of 5.5% post tax, real (including out-performance). If the cost of capital is set incorrectly, e.g. too low, then the required scope for out-performance will need to be higher if overall return expectations are to be met. It is worth noting that at this point in the process, we do not see scope for out-performance and indeed, in many areas, under performance is likely.

   It is absolutely essential that DNOs are adequately funded to meet their efficient operating costs and to earn a return on the capital employed. We do not believe that the significant cuts in our opex and capex submissions are justified. We have written separately to Ofgem on our specific concerns and reiterated the key issues elsewhere in this response. We could not accept a settlement that did not provide scope for the most efficient DNOs to innovate and outperform on the return required by their investors.

   We do not believe that it is appropriate to set a different cost of capital for different DNOs. This has never been considered appropriate or necessary in previous price controls and we believe it would make it very difficult to determine relative levels of out-performance across the DNOs. It is also unclear why some DNOs should require higher or lower base returns.

3. **What comments do you have on our early views on how different incentives should be calibrated and the impact on customers' bills?**
   We strongly agree with Ofgem that it is inappropriate to cap and collar the overall returns that a DNO is subject to, but recognise that there may be certain elements within the price control package where caps and collars are appropriate to manage the potential exposure to customers and DNOs.

   We have always maintained that the package should allow an efficient DNO to earn at least a return of 5.5% post-tax real, including out-performance. We are concerned that the Initial Proposals contain no scope for out-performance. Both the IQI and DG incentive have been reduced in strength relative to DPCR4, and as yet we are unclear

what outcome can be expected from the losses incentive given the certainty over the reporting mechanism and targets.

Without access to Ofgem's high level scenario modelling, we have been unable to recreate the +57 / -58 bps range in Table 4.1 of 92/09. We are very sceptical of the use of probabilistic models to 'calibrate' the settlement package. The Monte Carlo analysis that Ofgem has relied upon generates statistically arbitrary results that cannot reasonably be used to give indicative ranges of DNO performance. Our assessment of our ability to out (or under) perform is based upon the knowledge of our assets and our operating regime, as well as experienced judgement on the potential to save through innovation. Using a Monte Carlo simulation package to determine the likely range of out / underperformance available to a DNO has no grounding in operational reality.

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

We are keen that Ofgem applies a limited number of uncertainty mechanisms, focused on areas that are outside the DNOs' control. To this end, we believe Ofgem's proposals are broadly correct, but would challenge the assertion that the IQI mechanism is sufficient to manage input price risk.

The proposed increase to the IQI incentive rates increases this exposure relative to previous price controls and, perversely, exposes those DNOs that have provided the most accurate forecasts the most to this downside risk. We have previously put forward our view of an appropriate mechanism to manage the risk of significant changes in input prices. In the absence of such a mechanism, we believe Ofgem should change the current symmetry of the IQI mechanism to ensure that those DNOs that submit the most robust forecasts are not subsequently worst affected by adverse changes in input prices.

In addition to the uncertainty mechanisms proposed by Ofgem in its Initial Proposals, a re-opener will be required to secure the future and unique arrangements on Shetland. We will continue to work with Ofgem to develop a suitable mechanism for DPCR5.

93/09

CHAPTER 1: LOW CARBON NETWORKS FUND

Key Message:-

§ **We commend Ofgem on its proposed Low Carbon Network (LCN) fund. We believe this is proportionate to the scale of the challenge and look forward to working with Ofgem over the coming weeks to ensure that the risk-reward balance is appropriate to drive the behavioural change sought.**

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

   We recognise the importance of acting now to ensure that the networks are well-positioned to adapt and respond to the future needs of the market and environmental objectives. As such, we are extremely supportive of the work that Ofgem is doing in this area and are keen to ensure that the eventual mechanism is as effective as it can be in driving the 'right' behaviours.

   We believe the proposed mechanism is a very positive start in terms of scale, ambition and breadth of scope, and shows considerable commitment on Ofgem's part. We agree that there should be two tiers to ensure that smaller projects are not over-shadowed. We are, however, concerned that there is no real incentive to drive the strength of behavioural change that is needed.

2. **In particular, do you agree with: (i) the proposed size of the funding; (ii) the proposals for discretionary rewards; (iii) the two tier structure; (iv) the proposals to recover tier 2 costs over a five year period; and (v) the measures to mitigate DNO risk?**

   We believe the size of the fund is commensurate with the size of the challenge. In line with the likely deployment of technologies, we believe there may be merit in back-weighting the fund, i.e. with more funding being made available in the later years of DPCR5 relative to the initial years. This is likely to better align with the number of eligible projects across the period and therefore maximise the use of the funds that are available.

   We believe the two-tier structure proposed, and the relative weighting, is correct to ensure that smaller projects are facilitated and unnecessary bureaucracy is limited. Work is still needed to ensure that the method of allocation of 'tier 2' funding is appropriate. Where the annual allowance is over-subscribed, we agree that the allocation of this fund should be determined by an independent panel of experts.

Notwithstanding these positive elements of the mechanism, we consider the use of *ex-post* discretionary rewards, coupled with the level of DNO risk, to be insufficient. Behavioural changes are driven by sharp, strong incentives. At present, Ofgem's proposal leaves DNOs exposed to at least 10% of the project costs. Whilst we recognise that there is potential upside from undertaking an innovative project, for example, through improved efficiency, reduced environmental impact, etc., these benefits (and any *ex-post* reward for learning) are not guaranteed (and have been reduced through other reforms, such as equalising incentives). This therefore raises the question why a DNO would take the risk of embarking on an innovative alternative, particularly given that the expenditure for the conventional solution should already be in its allowance? Instead, we believe Ofgem needs to consider a stronger incentive / reward to ensure that DPCR5 is not a missed opportunity.

One way to do this would be through the cost recovery mechanism. We understand Ofgem's rationale for considering a shorter depreciation period. We believe this is consistent with the nature of the investment and ensures that current customers pay for this learning. We believe 100% of LCN spend should be capitalised and that Ofgem should look to apply a higher rate of return to this spend in recognition of the risks involved. We suggest 1% above the WACC. This would start to ensure that this is an incentive mechanism rather than solely a cost-recovery mechanism.

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

We are concerned that the proposed mechanism does not adequately reward DNOs for the level of risk that they are exposed to in trialling innovative technologies on their networks.

Whilst we understand that the level of risk to which the DNOs are exposed is predicated on the scale of the benefits put forward at the time of application, and capped at 50% of the benefits that fail to be delivered, we remain concerned over the potential level of exposure, relative to the little defined upside as a trade-off to taking this risk.

Whilst basing this exposure on the proposed benefits would naturally drive the DNOs to understate any likely benefits, we assume that this is countered by the project selection process, whereby only projects with the greatest anticipated benefits will qualify for the funding. As such, the potential exposure may be greater than might otherwise be expected by Ofgem.

We therefore believe that as well as the percentage cap on exposure, there should be a backstop position in the form of an overall value cap.

4. **Do you agree that DNOs should be allowed to use any benefits accrued from the project to cover their contribution (minimum 10%) 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% of the project cost?**

   We do not see any attraction in fixing the DNOs' funding fraction at 10% or more of the project cost. Instead, we believe ways to mitigate this exposure should be actively encouraged, if not provided by the mechanism itself. As a minimum, we believe DNOs should be allowed to use benefits accrued to cover their contribution shortfall. However, given the nature of these projects, we expect many to have little or no direct financial benefits to the DNO, but rather stakeholder and environmental societal benefits.

5. **Do you agree that the funding should be provided on a use it or lose it basis, and should the tier 2 funding be ramped over the period?**

   We believe the best approach is to allow for a profiling of allowances as outlined in Ofgem's Initial Proposals, i.e. a ramping up over the period. If, however, Ofgem continues with a fixed annual allowance, we do not see the benefit to customers of making each year's allowance only available on a 'use-it-or-lose-it' basis.

6. **Do you consider that this mechanism will achieve our stated objectives?**

   As stated in our response to Q2 of 92/09, we are concerned that despite the good work that has gone into designing the fund, it is let down on the basis of its incentive properties. We believe Ofgem should reconsider how it turns the proposed cost recovery mechanism into an incentive mechanism that actively drives the change in approach needed. We have suggested that these costs should be 100% capitalised and subject to a higher rate of return.

   In addition, we understand that Ofgem is reconsidering its suggestion that the owners of intellectual property rights should provide free licences to all GB network licensees. This change is welcomed as it would clearly not be practical to ask third party developers to forego their intellectual property rights.

   Finally, whilst we understand that Ofgem is keen to ensure that all DNOs actively embrace innovation, if not their own innovative ideas, then the learning of others, we believe Ofgem should keep in mind that some ideas will be network-specific and not necessarily suitable for wider roll-out.

CHAPTER 2: PROVISION OF INFORMATION TO DISTRIBUTED GENERATION

Key Message:-

- **We are generally supportive of Ofgem's proposals to improve the provision of information to facilitate Distributed Generation (DG). It is key that any resulting licence condition captures the pragmatic and flexible approach that has been adopted to date.**

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

Whilst we recognise the need to provide good information to guide applicants, and particularly first-time applicants, through the early stages of project development, our experience and feedback from our stakeholders, supported by the ENA's response to the DG Connection Process, indicates that applicants rarely seek to interact with DNOs in the way that Ofgem has indicated in its Initial Proposals.

For example, we find that developers tend to seek a formal connection to our network at the very early stages, and then progress their proposals through Local Authority consent and financial backing, before coming back to us to finalise their proposals. In this sense, unless the approach taken by developers can be reviewed and formally set out, we believe care needs to be taken in mandating standards, for example in relation to budget quotes, when this is not always something that is sought by the developers themselves.

Similarly, in terms of the information that is made available, we do not agree that information setting out the best connection opportunities will necessarily have an impact on developers' plans. It is unusual for developers to determine the location of their development on the basis of spare network capacity.

Notwithstanding the above concerns, we welcome practical improvements in managing the current interface with developers. We believe a collective DG Connections Guide, which is updated annually to ensure that it remains relevant to developers' needs, is a pragmatic way forward. However, we are less of the view that multiple new guaranteed standards are needed to deliver the proposed improvements, particularly given that each connection is different and will not necessarily lend itself well to an overall standard.

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

We support, in principle, the development of an information strategy as proposed by Ofgem, but would suggest an implementation date of 1 October 2010 in order to allow sufficient time to develop joint proposals and structure through the ENA.

In terms of the licence condition to require DNO-specific strategies for information provision, we believe the approach outlined to date is pragmatic. Providing the licence

condition remains high-level and allows the DNOs to prepare strategies that best reflect their networks, we believe this approach will provide greater transparency and structure to the current process.

3. **Do you agree with our proposal to request DNOs to commit to a strategy for information provision?**
   We believe Ofgem has outlined a pragmatic approach. It is not feasible in our SHEPD licence area to commit to providing capacity maps to developers in the way that Ofgem envisages. This is due to the high level of current applications, particularly at 33 kV, looking to connect to our rural networks. The volume of offers awaiting acceptance, plus those being processed, would make it extremely difficult to maintain an up to date capacity map that was of value to interested parties. Consequently, we welcome the flexibility that Ofgem has proposed in allowing the DNOs to identify the best mechanisms / approaches to achieving their information strategy. We believe that applicants can obtain a much better and more accurate view by speaking directly with the DNO.

CHAPTER 3: DISTRIBUTED GENERATION INCENTIVE FRAMEWORK

Key Message:-

§ **We do not agree with the proposal to weaken the DG incentive framework. This is inconsistent with steps being taken elsewhere to encourage and facilitate DG connection. Moreover, we believe it ignores the increased costs of connecting to a more constrained system.**

1. **Do you agree with our proposal to retain the DG incentive framework largely unchanged from DPCR4, and do you have any comments on the detail of our proposals?**
   We support the continuation of the DPCR4 framework for DG, but do not agree that it is largely unchanged. The proposed changes to the incentive rates are significant and will not adequately incentivise the DNO, particularly SHEPD which has had its incentive rate halved.

   In DPCR4, the costs used to calculate the incentive rate were based on the entire reinforcement costs. We understand that following the adoption of the 'shallowish' connection policy, the developer's share of reinforcement costs has been amalgamated into the connection cost paid by the developer, so the basis for the incentive rate, and the rate itself, has reduced. However, whilst we understand the rationale for making this change, and that *relatively* it might not represent a reduction in the DPCR4 rate, this does result in an *absolute* reduction in the strength of the incentive.

Our experience in DPCR4 has been that it takes several years for relevant generation projects to enter construction phase, with costs only becoming apparent in the later years of the period. In addition, projects in DPCR4 have tended to be able to connect to our network using spare capacity. This is now in short supply and a large number of recently contracted connections in our SHEPD licence area have required costly reinforcements, particularly in Aberdeenshire and Caithness where complete rebuild of existing circuits has been required. This requirement for reinforcement is certain to continue in DPCR5 based upon our existing contracts and as detailed in our FBPQ submission.

This being the case, we believe the incentive rate going forward needs to increase in line with the increasing need for reinforcement and the higher cost of the work generally. It does not seem logical that it should reduce against this backdrop. For these reasons, we do not believe that Table 3.2 in document 92/09, which appears to present DPCR4 costs, is a suitable indicator for the costs that will be incurred in DPCR5. Indeed, it is unclear that the DG incentive will provide sufficient revenue to cover DG connection costs.

Our SHEPD licence area is one of the most active in terms of DG connection. The proposed reduction from £2/kW/yr to £1/kW/yr is entirely inconsistent with steps being taken elsewhere to try to encourage and facilitate greater DG connection. We would suggest that the incentive rate should reflect the level of DG activity: where there has already been considerable DG connection, further connection is likely to require reinforcement and therefore expose the DNO to increased costs. Weakening the incentive sends entirely the wrong message at a time when DNOs are being asked to play an increased role in meeting 2020 carbon targets.

Notwithstanding our opposition to a reduction in the absolute incentive rate, should Ofgem press ahead with its revised incentive rate as set out in the Initial Proposals, it is key that provisions are made in the licence drafting to ensure that DG connected on the DPCR4 basis continues to be remunerated based on the incentive rate at which it connected.

Finally, all DPCR4 money has been expressed in 2005/06 prices, e.g. the incentive value of £1.50/kW/yr, the O&M allowance of £1.00/kW/yr, etc. We assume that the proposed values for DPCR5 will be inflated to 2010 prices.

CHAPTER 4: USE OF SYSTEM CHARGING TO PRE-2005 CONNECTED DISTRIBUTED GENERATION

Key Message:-

§ **We are concerned that the imposition of an obligation on DNOs to charge pre-April 2005 connected DG GDUoS, will result in both the industry (and Ofgem) being involved in protracted legal challenges, to the detriment and impedance of further DG connection.**

1. **Do you agree with our proposal to terminate the blanket exemption from use of system charges for pre-2005 connected DG, with effect from 1 April 2010?**

   We do not agree with the proposal to terminate pre-April 2005 connected DGs' blanket exemption from Use of System (UoS) charges with effect from 1 April 2010. We believe this fundamentally contravenes the grounds on which these generators connected to the network. Secondary to this, it contradicts the date previously proposed by Ofgem for implementing this change of April 2012.

   We have continued to press, most recently in our response to Ofgem's formal request for information, that DG that connected prior to 1 April 2005 did so under entirely different commercial and regulatory arrangements. Indeed, DG that connected prior to vesting did so at a time when there was no concept of connection and use of system. To now review, all these years later, the basis on which these generators are connected, and to potentially charge them for ongoing UoS, seriously risks altering or threatening the financial viability of these projects. This sends a very strong negative signal to the DG development community in terms of regulatory risk and is inconsistent with Government drives to increase new renewable generation.

   For those generators that have a connection agreement, it has been our understanding, and we believe the understanding of the DG connected to our network, that this agreement is an enduring contractual agreement between the parties. We are therefore surprised and concerned by Ofgem's assessment that it has found no evidence of evergreen rights in the sample of connection agreements that it has analysed to date. This is at odds with our findings and we would welcome further detail from Ofgem to explain the basis of this statement. It is reasonable to expect that the owners of the relevant DG schemes would also welcome this clarity given that they will be most affected by this statement.

   We do however agree with the suggestion in the Initial Proposals that payments by DNOs to affected DG would be appropriate to compensate for changes in DG rights. However, the practicalities of establishing a methodology under which such payments would be calculated, and the application of that methodology in a manner that meets audit requirements with, in most cases, minimal historic records, reference system or cost data,

represent an enormous resource challenge to the DNOs. This would also need to be funded by Ofgem through the price control, including the administration costs.

Our reasonable expectation is that this would require a full-time team of skilled and experienced staff to sift through and assess historic connection arrangements, where these are indeed in place. These resources would be diverted from planning and developing the current system as it would be unrealistic to outsource this work. Further associated commercial and legal resources would also be required to interface with the affected DG parties and reach agreement (where such agreement was achievable).

Clearly, DG affected will seek to maximise the value of compensation payable, potentially with the use of specialist advisors. In some cases, changes of ownership will inevitably have taken place since the original DG connection was provided, raising questions of who the DNO is expected to compensate and on what basis. Moreover, we believe that attempts to 'unpick' the historic arrangements, potentially involving prejudice to the property rights of the generators, will lead to disputes, determinations and, in all reasonable likelihood, legal challenges involving both the DNOs and Ofgem. We would expect Ofgem to fund this and maybe also be party to defending such claims, but note that this has not been mentioned in the Initial Proposals. The issue of compensation is clearly difficult and is an unhelpful cost and resource issue at a time when cost efficiency and optimal resource allocation is under review.

Importantly, we believe the two-tiered framework proposed within the Initial Proposals is completely unworkable. The proposition that generators that connected under the same prevailing methodology could be treated differently depending on the availability or otherwise of records detailing their connection arrangements, is wholly open to legal challenge. DNOs are obliged to treat generators uniformly on the basis of the prevailing methodology at the time of connection. Any deviation from this can reasonably be interpreted as discriminatory.

We have had experience of a compensation exercise through our transmission business, Scottish Hydro Electric Transmission Limited (SHETL). However, this was on a much smaller scale. The SHETL compensation scheme involved only six generation sites and, due to the scale and value of the assets deployed, some relevant historic information was available. Nevertheless, the resolution of compensation for these six sites was extremely time and resource intensive. Our affected customers quite reasonably required detailed explanation of:

(i) How the boundaries were determined;
(ii) How the asset valuations were arrived at;
(iii) How the methodology for depreciation and indexation was applied; and
(iv) How shared cost allocations (e.g. for civil works) were assessed.

In all the exercise took in excess of a year to resolve.

In contrast, our two distribution licensees would potentially have to engage with the current (and potentially past) owners of hundreds of DG sites. This would be a huge exercise that would take years to complete.

Finally, we are aware that Ofgem carried out an outline impact assessment (IA) as part of its Policy Paper. We provided a critique of this outline IA at the time. We are surprised that a full IA has not been included in the Initial Proposals. We believe one is essential before the final proposals.

CHAPTER 5: TRANSMISSION EXIT CHARGES

Key Message:-

§ **We do not agree with the proposal to introduce an incentive mechanism in this area. We believe the opportunity for DNOs to influence transmission exit charges more than they do at present is limited.**

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

We have consistently argued, along with all other DNOs, that a DNO is not in a position to materially influence transmission exit charges. We are disappointed that Ofgem continues to waste time and effort developing an incentive mechanism that will have no material impact on the level of transmission exit charges in DPCR5. The resource spent in this area would be more usefully employed ensuring that key outstanding environmental incentives, such as losses and the new Low Carbon Network fund, are fully developed for the Final Proposals.

There is already a positive incentive on National Grid Electricity Transmission (as both System Operator (SO) and Transmission Owner (TO)) and the two Scottish TOs to minimise exit charges. These discussions take place regularly across GB. Ultimately, however, the investment decision sits with the GBSO and TOs, not the DNOs.

All DNOs have previously committed to more formally encouraging the three TOs to minimise exit charges during the transmission price control stakeholder engagement programme. We proposed that Ofgem requires the TOs to involve all stakeholders in assessing TPCR capital programmes and, in particular, DNOs where those programmes impact grid supply points (GSPs). In our view this is an appropriate and proportionate response to Ofgem's desire to encourage DNOs to take a more active role in seeking to minimise exit charges.

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

   Notwithstanding our fundamental objection to the proposed incentive, if Ofgem is intent on imposing this incentive, we believe focusing on reinforcements and new GSPs is the most appropriate. However, it is important for Ofgem to understand that DNOs forecast the likely exit charges based upon the expected gross asset value of the new or reinforced GSP. These are obviously susceptible to changes in input prices, particularly towards the latter part of DPCR5. As these assets are not purchased by the DNOs, we have no control over changes to the input prices. It would therefore be necessary to ensure that any incentive mechanism is neutral to fluctuations in input prices. That is, the incentive should be designed to incentivise the DNO to seek to influence the TO to minimise the capacity (the physical assets) rather than the price *per se*.

3. **Do you agree with the level of exposure under the proposed sharing factor?**

   The proposed exposure level of 20% appears reasonable. However, it is essential that if this incentive is imposed on DNOs, it is only switched on for those that have forecast expenditure in the areas of the proposed incentive. For example, SHEPD has forecast expenditure of £11.8 m for the proposed incentivised portion of transmission exit charges; SEPD has forecast £0 m. It would be completely inappropriate to expose SEPD to the (solely) downside risk of any unexpected reinforcement (or indeed new GSP).

CHAPTER 6: LOSSES INCENTIVE

Key Messages:-

- **We welcome Ofgem's proposal to fund investment in low loss equipment. This input element is a positive addition to the mechanism.**
- **We are, however, concerned that the proposed changes to the existing output element in terms of the reporting methodology, are not adequately developed or understood to incentivise the DNOs from 2010/11.**

Ofgem is aware of our concerns in relation to the proposed changes to the way in which DPCR5 losses will be reported. Our main concern is that the proposed methodology is still under development and still untested and, as such, there is a real risk of unintended consequences. Implementing this change may exacerbate Ofgem's concerns over windfall gains and losses rather than mitigate the perceived excessive rewards realised by some DNOs during DPCR4.

We have previously proposed that the new losses incentive mechanism should run alongside the current mechanism for a period of 'bedding in' at the start of DPCR5 (with the incentive properties switched off). If the current mechanism was rolled forward for the first two years

of DPCR5 this would ensure that the new incentive mechanism was fully proven before its incentive properties were switched on. Whilst we are comfortable with setting targets for the new incentive based upon latest available data, we know that other DNOs have concerns in this area. Allowing a two-year bedding-in period would mean that RF runs could be used to set the target for the new incentive.

We believe Ofgem should seriously consider this option.

1. **Do you agree with our proposal to provide explicit funding for justified low loss investments to provide direct recognition of the investment?**
   We believe this is a positive addition to the current mechanism and demonstrates Ofgem's commitment to the issue. A hybrid mechanism will allow the DNOs to start to address technical losses, whilst at the same time ensuring that the current focus on identifying and reducing non-technical losses is not lost.

2. **Do you agree with our proposals (common reporting, reporting lag) to address the issues associated with using settlement data to measure losses?**
   Whilst we believe it is logical to move the DNOs to a common reporting methodology, we believe the work to date has demonstrated just how complex an area this is. Moreover, with no prior experience of this method of reporting losses, we have concerns that the data will prove volatile. As already stated, our preferred approach is to trial this methodology alongside the DPCR4 mechanism in the first instance. If however Ofgem presses ahead with its proposal to introduce this new approach in 2010/11, we will continue to work with Ofgem to achieve a workable outcome. As part of this, we believe Ofgem may have to accept a degree of flexibility in the methodologies applied to avoid significant system costs and process changes.

   Importantly, any changes to the DNOs' reporting methodology to establish a common approach for the purposes of the incentive should not interfere with the way in which losses are measured / reported for other parts of the DNO's business, for example loss adjustment factors (LAFs).

   In terms of the proposed reporting lag, the precedent has been set with the Interruptions Incentive Scheme (IIS) and, as such, we believe this is the most pragmatic solution to ensuring greatest confidence in the accuracy of the data.

3. **What are your views on our proposals for a common reporting method and where we have identified options, which do you prefer?**
   In trying to get to a common methodology, we believe Ofgem will have to accept a degree of flexibility in the data sources used. We believe this should be combined with the option of using the bottom up or hybrid approach. It would seem pointless to permit a choice of data sources, only to compel all DNOs to use the same approach as selected by Ofgem. If Ofgem wants to ensure a completely uniform approach, the way to do it would

be to establish a losses-specific flow through Elexon. This option would take some time to implement, but could offer the best long-term solution.

In terms of the proposed target-setting methodology, we support Ofgem's proposal to update targets to reflect DPCR4 performance. Notwithstanding our view that there may be merit in trial-running Ofgem's proposed new reporting methodology for the first two years, we agree that for the purposes of the DPCR5 losses target, it is acceptable to use the best available data at the time, rather than waiting for the final settlement data from 2009/10. We would prefer to have upfront certainty on our target levels going into the DPCR5 period.

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

   We are disappointed with the proposed losses incentive value of £60 / MWh, which reflects a very small increase from the current value. We are concerned that, once implemented, this may not be sufficient to drive the correct behaviours.

   We note in paragraph 6.10 of 93/09 that Ofgem is keen to avoid DNOs gaining incentive benefits by outperforming their target, whilst at the same time increasing their losses across the period. Clearly this concern has arisen from the incentive revenues that have been earned by some DNOs during DPCR4. However, this initial gain will be corrected by the present losses roller mechanism. We therefore continue to stress the importance of allowing this mechanism to play out into DPCR5, both to ensure equal reward for reductions in losses regardless of when in the period they are made, and to ensure that incentive payments reflect genuine loss reductions over the period.

   We believe the proposed caps and collars for DPCR5 performance are reasonable, but firmly believe that they should be set on an annual basis, rather than the proposed five years.

5. **Do you agree with our proposals for a common treatment for substation energy usage, where the substation usage is registered with a supplier so that they pay for the electricity consumed?**

   We agree that it is appropriate to register all substations through settlements. Where energy usage is *de minimis,* or the installation of meters is impractical, we believe it is more pragmatic to register these sites as unmetered supplies (UMS).

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

   Losses measurement (as opposed to calculation or estimation) requires the use of metering, where units entering and units leaving can be measured at a common time interval. A wholly adopted smart metering system may deliver this (notable exceptions being UMS), but DNOs are no longer responsible for metering. In any case, Ofgem

should be mindful of not being seen to favour particular approaches. There may be other steps that can be taken to improve data quality, for example working with suppliers to actively target theft, and it is important that Ofgem does not overlook the value of such initiatives.

CHAPTER 7: TREATMENT OF DPCR4 LOSSES ROLLING RETENTION MECHANISM

Key Message:-

§ **We strongly advocate that Ofgem allows the losses roller mechanism to run as intended in the DPCR4 Final Proposals. This will ensure that only sustainable improvements in losses during the DPCR4 period are rewarded.**

1. **Do you agree with our proposal to leave the DPCR4 losses incentive open for the first three years of DPCR5 until the settlement corrections are complete? What are your views on our proposal that the absolute losses performance will be exposed to the DPCR4 rolling retention mechanism?**

   Our calculation of system losses is based on the data at the time of producing the annual accounts and is not subject to subsequent revision. Therefore, whilst we do not revise or make provision for change to the settlement data in the calculation of our losses for the losses incentive, we recognise and endorse Ofgem's proposal to allow those DNOs that do make provisions or revise their calculations on the basis of later settlement data, to be allowed to reflect this RF data in their losses performance.

   Importantly, DPCR4 losses performance, as implemented through the roller mechanism, must not be included in the cap and collar arrangements for DPCR5. Otherwise, there is a risk that inappropriate returns may be retained. It should also be noted that no such caps and collars applied during the DPCR4 period.

2. **Do you consider that the proposals for closing out the DPCR4 rolling retention mechanism have merit, and if so, how should we manage the uncertainty?**

   No, we do not believe Ofgem's proposals will be workable in practice. We believe DNOs should be fully exposed to their DPCR4 losses outturn performance, as envisaged by the losses roller mechanism set out in the Final Proposals.

CHAPTER 8: BUSINESS CARBON FOOTPRINT REPORTING

Key Message:-

§ **We believe Ofgem has proposed a proportionate and pragmatic approach to business carbon footprint (BCF) reporting.**

1. **Do you agree with our proposal for BCF reporting requirements?**

   We believe Ofgem has set out in its Initial Proposals an appropriate reporting structure for the DNOs' business carbon footprint that is proportionate to the environmental impact. Going forward, we do not believe it is necessary to move all DNOs to the same method of reporting. Given that the intent of this exercise is to identify *absolute* changes in a DNO's emissions year on year, we believe the focus should be on establishing a robust baseline for each DNO, and ensuring consistency in each DNO's annual reporting thereafter.

   Consistent with a proportionate approach, we agree that the information provided by the DNOs can be used to construct a league table showing the percentage change in emissions year on year. However, given that this data does not give any relative indication of how carbon efficient each DNO is, it cannot be used to infer carbon intensity.

   In terms of the data being sought, we have identified to Ofgem, through the relevant process, where we have had data collection issues. Notwithstanding these issues, we believe our submission in August was robust and provided valuable learning for our 2009/10 reporting.

2. **Do you agree with the proposed guidance for the BCF reporting methodology?**

   Yes, we believe the proposed guidance is fit for purpose.

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

   Yes. Given that the reporting is designed to capture *absolute* emissions and does not account for DNO size and hence carbon efficiency, we believe this data can only be presented as a league table showing the percentage change in emissions year on year.

CHAPTER 9: UNDERGROUNDING IN AREAS OF OUTSTANDING NATURAL BEAUTY AND NATIONAL PARKS MECHANISM

Key Message:-

§ **We believe Ofgem has applied a pragmatic approach to rolling forward the undergrounding allowance into DPCR5.**

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

   We believe Ofgem has taken a pragmatic approach to the changes proposed. We agree with the removal of the voltage caps and the use of stakeholders to act as a back-stop to ensure that more costly projects are contingent upon the agreement of the relevant stakeholders. Similarly, we understand why the extension of the scheme may be difficult.

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

   We agree that there needs to be clear arrangements for works that started in DPCR4 that will not be complete by 31 March 2010. We would suggest that the 1 April 2010 deadline for energisation is removed, but that a single deadline for carry-over projects to be completed and dismantled by 1 April 2011 is agreed. This will ensure that projects planned for DPCR4 are carried out.

CHAPTER 10: CONNECTIONS INCENTIVES AND OBLIGATIONS

Key Messages:-

§ **We believe the proposed connections incentives and obligations are a backward step that will reduce our ability to respond directly to our customers' needs.**

§ **The penalties for failing to meet any standards must be proportionate; we believe gas is a good proxy.**

§ **We strongly welcome Ofgem's approach to developing competition in connections and the recognition that a DNO could retain (or increase) its market share whilst operating in a competitive market. To this end, the two-pronged approach to assessing competition as outlined is strongly supported.**

§ **If Ofgem is serious about encouraging new entrants, we believe the regulated margin needs to be higher; we believe a margin closer to 8%-10% is more appropriate.**

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

We believe that the standards, as proposed, apply at a level of granularity that is unhelpful. Whilst we agree with the new standard to make contact with customers immediately after a quote is accepted, we do not believe that there is a need for standards relating to the agreement of a detailed programme of works at this time. In our experience, customers are rarely in a position to commit to a commencement date and completion date at this point in the process. As such, we believe the proposals are a backward step.

We believe the imposition of detailed standards will be to the detriment of customer service and efficiency in new connections. Both DNOs and IDNOs will be constrained in terms of the level of flexibility that they can adopt to alter, for example, existing work programmes to accommodate customer changes, which are a regular feature of this type of work. In our experience, work programme changes are more likely to be driven by customers rather than the DNO. It will be key that the guaranteed standards are designed to ensure that the impact of these changes is not unfairly stacked against the DNO.

In order to deliver these standards, more resources would need to be factored into our cost allowances. As a minimum, we believe steps should be taken to streamline and simplify the proposals between now and Final Proposals, such as reviewing the need for a detailed programme of works at the time of accepting a quotation.

In terms of the proposed penalties, we strongly disagree with the levels put forward at this stage in the process and the initial suggestion that these should be uncapped. In gas, comparable standards exist, but the incremental daily penalties are more proportionate, and the DNs' exposure is capped at levels commensurate with a party's loss. Moreover, appropriate caveats are included in gas to allow for instances where the applicant has submitted incomplete or inaccurate information. As the proposals stand at present, we do not believe the penalties are proportionate.

In support of this, Ofgem will be aware of the significant disagreement at the ECSG sub-group meeting where these new standards and penalties were developed. To be clear, the levels stated in the Initial Proposals are not unanimously supported.

We particularly disagree with the specific proposal to charge a £50 penalty for non-attendance at site for Emergency Response. Whilst we support the principles of penalty arrangements in unmetered connections, we fundamentally disagree with the proposals for a £50 penalty for non-attendance. As set out in the Service Level Agreement (SLA), this is an activity which is chargeable to the Local Authority. As such it is inappropriate for DNOs to be penalised when they are unable to meet the standard. It is inconceivable that DNOs would deliberately delay responding to such a safety-related incident and would, in all cases, attend site as soon as possible. We see it as reasonable to set a

standard in the SLA, but unreasonable to include penalties for times when this cannot be achieved. In addition, there are some locations in our licence area where it would not be possible to achieve this standard due to remoteness, and this needs to be reflected in the exemptions.

Notwithstanding the above concerns, IT changes tend to require at least six months to implement. The proposed standards will require major changes to the DNOs' IT systems. As such, the standards cannot be introduced until these systems are in place. Practically, we do not believe the new standards can be implemented in advance of October 2010.

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

   No. This would be wholly inappropriate and disproportionate.

3. **Should we cap the penalties that apply to each of the proposed standards?**

   Yes. These should be capped in line with the current penalties that apply in gas distribution and at a level that is commensurate with the value of the service provided. It is unreasonable in a commercial context to place an uncapped liability on the service provider in the way proposed.

4. **Should we apply in aggregate a 90% performance target to apply to the standards and measure this on a quarterly basis?**

   Whilst we agree with the 90% threshold level, we believe this should apply on an annual basis rather than quarterly. This is consistent with the standard required by gas transporters.

5. **Do you agree with our market segmentation strategy for metered and unmetered connections? Are there any segments other than those identified that should be exempt from earning a margin?**

   We believe the proposed segmentation arrangements are appropriate. Ofgem has identified the right segments that should be eligible to earn a margin.

   On the specific issue of unmetered Private Finance Initiative (PFI) funded connections, the user group is already fully aware of the options open to them in Competition in Connections. As such, we believe contestable works in this market segment should be immediately eligible to earn an unregulated margin. This would recognise the high likelihood of the PFI contractor considering carrying out the contestable works under the Triangular Agreement, and allow the works to be tested on an open commercial basis, including both service and price. Moreover, the unregulated margin would best provide potential headroom for independent connection providers (ICPs) to be successful.

6. **What are your views on the proposed level of regulated margin and is there any further evidence we should take into account in setting the level of regulated margin?**

   The level of regulated margin proposed in the Initial Proposals is completely inappropriate. For the regulated margin to be effective and to actively encourage new entrants to participate, it needs to be at a level that allows new entrants the opportunity to earn an attractive margin. We would suggest that a margin of 8-10% is not unreasonable and certainly more appropriate in terms of encouraging competition and driving improved service levels than the currently proposed 4%.

7. **Do you have any comments on the scope of the proposed competition tests?**

   We welcome Ofgem's proposed two-pronged approach to determining whether competition is effective. This is consistent with our opposition to a set of tests that focused entirely on market share, or which required the DNO's market share to reduce to a certain threshold in order to demonstrate that its service area was open to competition. We have always maintained that a host DNO could retain a large share of the market in its area, even with active facilitation of competition in a competitively attractive area, due simply to its excellent performance and service levels. Such a DNO should not be discriminated against and precluded from earning a margin. The tests therefore need to be capable of recognising well-performing DNOs that retain market share in competitive conditions. Indeed, removing the margin from these DNOs would be counter-productive. This would preclude all likelihood of competition developing in this area and remove any incentive on the host DNO to continue to outperform.

   Whilst we welcome the two-pronged approach to determining competition, we believe further work is needed between now and Final Proposals to develop the proposed 'pure competition tests'. We question, for example, how appropriate the Herfindahl-Hirschman Index (HHI) is for this application, and how realistic the proposed threshold of 1,000 is. This would require the host DNO to lose more than two-thirds of the connections market in its area. We would doubt whether this level has even been achieved in the competitive energy supply market. Even an HHI of 1,800, which is at the upper end of the range deemed to demonstrate a moderately concentrated market, would appear unrealistic. We therefore do not believe this is an appropriate test of market share in this instance.

8. **We invite views on the relative weighting of market share compared to the price and service tests? What level of lost market share would be appropriate to deem the market competitive?**

   Our response to Q7 reiterates our position that market share must not be regarded as a key indicator of competition. Indeed, Ofgem itself acknowledges this in para 10.41 of 93/09, where it states that the competition tests should *"recognise that DNOs could retain (or increase) market share by delivering competitive prices and service levels"*. It is therefore not appropriate to apply a weighting to the different tests. A DNO, operating in a market segment deemed to be eligible to earn a margin, that is able to demonstrate that

there are no barriers to competition, must be able to pass Ofgem's competition assessment regardless of its market share. We therefore support the 'two-pronged' approach illustrated in Figure 10.1 of 93/09.

Separate to this, where a DNO is unable to demonstrate competition, we would suggest that the proposal to refund any regulated margin earned over the period to those customers that incurred the margin, is both unrealistic and unworkable in practice. It is likely that a more mechanistic approach will need to be developed.

CHAPTER 11: BROAD MEASURE OF CUSTOMER SATISFACTION

Key Messages:-

- **We believe the mechanisms outlined have the potential to deliver noticeable and measurable improvements in customer service during DPCR5. We believe Ofgem should, therefore, consider implementing this measure from 2010/11 and with the slightly greater revenue exposure of +1.25% / -1.125%.**
- **We believe there are significant benefits to be gained from a proven and tested advocacy-based customer satisfaction survey. We recommend that this forms the main component of the measure, with +1% / - 1% of revenue being exposed.**

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

We strongly support the proposal to introduce a broader measure of customer satisfaction. The current measures are limited in their scope in terms of truly understanding customers' perceptions of the service levels received. We believe the chosen categories for the new broader measure fairly reflect the attributes that are key to customers and, as a group, could give a robust output if weighted correctly and properly defined.

Our recent experience of using an advocacy-based system for measuring customer satisfaction has led us to conclude that:

- A properly proven and tested advocacy system is a very powerful measure of customer satisfaction;
- Such systems not only measure true customer satisfaction, but also indicate areas for improvement; and
- Outputs from these measures correlate very strongly with related measures such as complaint rates.

For these reasons, we would urge Ofgem to ensure that any system it employs is market-tested and has proven metrics that work in the 'real world'. Customer satisfaction is a difficult area to measure robustly. By using a market-tested measure, this will give confidence in the credibility of the initiative. Secondly, having gone to this effort, we

believe that the customer satisfaction survey should form a worthwhile proportion of the broader measure. Internationally recognised customer satisfaction surveys provide a real means of gauging a company's ability to give customers the service they require and expect. They reflect a true cross-section of customers and can be used to identify leading indicators of customer satisfaction if used correctly.

In comparison, a complaints metric is very much a lagging measure of customer satisfaction that centres on a small proportion of the customer base. Without wishing to diminish its importance as an indicator of service levels, we strongly recommend that Ofgem considers reducing the complaints metric's potential revenue exposure in favour of the customer satisfaction metric.

Stakeholder engagement has been a powerful tool in forming our price review submission. We have gathered important, structured and often passionate views from our various stakeholders during the last year, which have enabled us to make an informed and robust submission to Ofgem. Going forward, we recognise the merits in maintaining a certain level of engagement to ensure that we continue to respond to our stakeholders' needs. It is, however, difficult to see how the effectiveness of this engagement can be measured by Ofgem without involving Ofgem in each of these interactions. We do not believe the frequency of stakeholder engagement or the size of any such events should be taken as a measure of a DNO's effectiveness in this area. Instead, we believe the emphasis should be on some sort of satisfaction survey, possibly as a subset of the overall customer satisfaction survey outlined above.

In terms of timing, we are disappointed that Ofgem is proposing to delay the introduction of the broader measure. We believe the introduction of the broader measure will bring about some of the most noticeable benefits to customers and stakeholders and is an area that is, at present, inadequately addressed. We believe it is entirely feasible that this measure could be in place for the start of the price control without unintended consequences. In turn, this would alleviate concerns that have been raised about signing on to a package without fully developed and finalised mechanisms.

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

Given the importance of customer feedback to both our customers and stakeholders, and the implications that this has in terms of improving our business, we have continued to encourage Ofgem to make this a strong incentive area. We would therefore support a stronger incentive than the one proposed: we suggest +1.25% / -1.125% of revenue. We believe the emphasis should be on the customer satisfaction survey element given its wider remit and the fact that it is likely to be the best overall indicator of customer satisfaction. To this end, we propose +/- 1%, with +/- 0.125% applying to the complaints metric and +0.125 % to stakeholder engagement.

CHAPTER 12: TELEPHONY INCENTIVE SCHEME

Key Message:-

§ **We question the value and the appropriateness of the proposed changes to the telephony incentive. Given that the scheme is earmarked for expiry, we believe time and resource would be better focused on developing the broader measure.**

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

   We do not see any real benefits in the changes that have been outlined. Arguably, streamlining the attributes reduces the breadth of information gathered from customers and dilutes the value of an already weak service measure.

   Including unsuccessful calls in the measure presumes that we fully understand the reasons as to why a call is unsuccessful and that this is, in some way, a measure of customer satisfaction. It also implies that customer dissatisfaction is linked to the level of unsuccessful calls, when in actual fact a low level of unsuccessful calls may simply reflect a higher level of automated call answering. We therefore do not believe that a low level of unsuccessful calls can be correlated with greater customer satisfaction. As a minimum, we therefore believe that Ofgem should look to reduce the weighting attributed to unsuccessful calls. However, our preference and recommendation would be that the scheme is left as it is and efforts in the period leading up to final proposals are concentrated on the broader measure.

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

   Notwithstanding the above points, Ofgem's proposals and methodology for recasting the reward and penalty thresholds seem reasonable.

CHAPTER 13: WORST SERVED CUSTOMERS

Key Message:-

§ **We welcome the introduction of a worst-served customer (WSC) allowance and are keen to work with Ofgem to ensure that the mechanism is as effective as possible.**

1. **Do you agree with the proposed mechanism (in full) for worst served customers?**

   We agree with the need for a mechanism and are very supportive of the proposed allowance. We believe that a number of our worst-served customers (WSCs) will be able to benefit as a result of this proposal.

   In order to minimise bureaucracy, we would like to see the mechanism administered in a way that allows us to blend our existing capex and opex programmes seamlessly with work to improve WSCs' service levels. In particular, we would be keen to minimise requirements to arbitrarily separate routine spend from "additional" spend. We believe the focus should be on nominating customers in advance of improvements and subsequently validating that performance improvements have been delivered.

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

   These customers are worst-served because of the high spend required to improve their service levels. As such, we do not believe a cap of £1,000 per customer is sufficient to improve service levels to the very worst-served customers on our network. It will, however, make a difference to a proportion of these customers and to this end it is positively welcomed. To have a more widespread impact, we believe the cap would need to be double the current level.

   Notwithstanding this, in order to minimise bureaucracy, and to remove the added complication of subsequently trying to isolate WSC spend from other spend on the network, we believe it may be more appropriate to fix the allowance for each WSC at a pre-defined rate. Having met the required performance improvements, this would give the DNOs greater clarity over funding in relation to WSCs.

CHAPTER 14: INTERRUPTIONS INCENTIVE SCHEME (IIS)

Key Messages:-

- **The proposed changes to the Interruptions Incentive Scheme (IIS) increase the DNOs' downside risk significantly. We believe an asymmetric incentive is needed to address this.**
- **In addition, we believe that the Quality of Service capex disallowed as part of the Initial Proposals needs to be reinstated. For SEPD, this capex is essential if the gap between its CML performance and target is to be bridged.**

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

   We understand why Ofgem has proposed that any required improvement from current performance should be paid for by shareholders. However, we disagree with this proposal for a number of reasons.

   Over the period of DPCR4, most DNO customers have seen an appreciable improvement in network performance. Our own extensive discussions with customers indicate that they are appreciative of this and generally acknowledge that performance levels have improved overall. However, they also indicate that their expectations are increasing and that they are no longer satisfied by the length of interruptions that they experience. This is arguably reflected in the most recent Ofgem customer survey.

   In our two licensed areas, CIs have reduced by almost 30% from starting target levels in DPCR4, and CMLs by between 21% and 34%. The proposed DPCR5 targets reflect these improvements and will therefore be difficult to achieve given the extent of progress that has been made.

   For SEPD, our CML target is currently well below our average performance over the last four years. We believe the target is a product of the calculation methodology rather than a true reflection of what we can achieve. It is therefore vital that Ofgem allows our request for additional capex to bridge this gap and put us on an even footing with other DNOs.

2. **Do you agree with the approach to setting pre-arranged allowances?**

   We acknowledge the logic of Ofgem's proposal for dealing with pre-arranged outages. This proposal fits with our own aim of demonstrating clear output measures for DPCR5. However, we are surprised by the reduction in SHEPD's pre-arranged CI and CML allowances for load and non-load. Our figures directly reflect an increase in workload in both of these areas and it is difficult to understand why Ofgem has made this reduction. We believe Ofgem should restore our pre-arranged allowances to the level asked for in

our FBPQ submission. This would increase load related CIs by 4.15 and non-load related CIs by 3.6. Load related CMLs should be increased by 3.35.

3. **Do you agree with the proposed levels of revenue exposure and incentive rates?**
   We are concerned that the proposed targets and the narrowness of some of the bands, i.e. the impact of a small increase or decrease in CIs / CMLs on performance revenues or penalties, do not reflect the true risk facing the DNOs in the forthcoming price review period. It appears to us that the downside risk is considerably greater than before and, as such, we do not believe that a symmetric incentive is still appropriate.

   To this end, we would urge Ofgem to review the possibility of an asymmetric incentive for DPCR5. Ofgem could, for example, consider applying its full incentive rates for DNO out-performance, but either apply a lower incentive rate for DNOs missing their targets or apply a reduced weighting to increases in CIs and CMLs. The existing treatment of pre-arranged outages is an example of where Ofgem has already applied this principle, and a reduction of 50% seems an equally appropriate reduction for unplanned outages to address the increased exposure.

   We also suggest Ofgem does not use a five year 'logging up' approach to caps and collars for the DPCR5 IIS scheme. We suggest it sticks with its well proven annual approach to mitigate the increased risk caused by the revised targets and increased sensitivity around CIs and CMLs.

4. **Do you agree with the proposed refinements to the exceptional events mechanism?**
   We agree with Ofgem's proposals for exceptional events in DPCR5.

CHAPTER 15: GUARANTEED STANDARDS OF PERFORMANCE

Key Message:-

§ **We are generally supportive of Ofgem's proposals in this area. We are keen to work with Ofgem to develop a suitable payment cap for large one-off events.**

1. **Do you agree with the proposal to increase guaranteed standard payment levels to reflect inflation?**
   This seems reasonable. Clearly, if we end up in a period of prolonged deflation, the payment levels should be amended to reflect this.

2. **Do you agree with the proposal to introduce some form of payment cap for large one-off events?**
   We agree a payment cap for large one-off events is appropriate and are keen to assist Ofgem with their investigations to establish the correct level.

3. **If you agree to the introduction of some form of payment cap, what is your preferred method?**
   A broadening of the potential types of event that are eligible for review under the IIS one-off exceptional events mechanism is our preferred method, with Ofgem taking into account historical evidence to date. We see merit in linking any payment to an independent review to ensure fairness of approach and equanimity of treatment across DNOs. We support a cap per customer for one-off events, as is already the case for severe weather events, and we support some form of cumulative cap on guaranteed standards' exposure.

4. **Do you agree that rota disconnection interruptions should be treated independently of the multiple interruption standard?**
   We agree rota disconnection interruptions should be treated independently of the multiple interruption standard. These are clearly one-off events that are not linked to the circumstances that GS2A is designed to cover.

CHAPTER 16: CUSTOMER SERVICE REWARD SCHEME

Key Message:-

- **We are generally supportive of Ofgem's proposals in this area.**

1. **Do you agree with our proposals for embedding DPCR4 best practice?**
   We agree with Ofgem that DPCR4 best practice is best driven through incorporating the key elements into the minimum requirements of the DPCR5 reward scheme. This is pragmatic and acknowledges the role of the new broader measure. Importantly, best practice needs to be defined at a high level to ensure that there is sufficient flexibility to allow the DNOs to deliver this best practice in the way that is best suited to their business model.

2. **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 the scheme should be rationalised following the introduction of the broader measure given that most areas will be incentivised by this measure and DNOs will have an appropriate focus on the key areas of customer service. However, Ofgem is correct to highlight that there will still be a number of areas not covered by this measure. As noted

by Ofgem, we agree that the revised scheme should reflect areas where DNOs exceed their social obligations, such as: remote community assistance; help for vulnerable groups; targeting the wider social impact of their operations; and using a holistic approach to community involvement (such as addressing transport issues in the broadest sense).

CHAPTER 17: NETWORK OUTPUT MEASURES

Key Messages:-

§ **We understand the rationale for output measures and have worked with Ofgem to develop a suite of high level output measures. We are however concerned by the level of granularity now being applied and the drive, contrary to intention, to develop a 'one-size-fits-all' approach.**

§ **We continue to support a qualitative, light-touch approach and believe there is merit in linking the degree of oversight applied to performance under the Information Quality Incentive.**

In our FBPQ submission, and in further workshops with Ofgem, we have committed to a suite of network output measures based upon our capital investment programme as per our submission. Whilst it appears that the volume of work that we have indicated for DPCR5 has been accepted, Ofgem has challenged our unit prices in a number of areas. In many of these areas, we believe Ofgem will need to revise its Initial Proposals. We have written separately to Ofgem on this expressing our concerns and have highlighted the main concerns elsewhere in this response.

We firmly believe that we have submitted robust and realistic capital investment plans in our FBPQ submission. If Ofgem is intent on reducing our unit costs, we will not be able to complete the volumes we proposed. As a consequence, some of the key output measures we have proposed will also be undeliverable, which will have a knock-on and detrimental effect on the health of our networks, which we have maintained efficiently and effectively to-date

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

   We have been very supportive of the development of high level output measures and, as part of our FBPQ submission, provided Ofgem with a comprehensive suite of proposed measures across the three broad themes of DPCR5. We continue to be supportive of output measures, but are concerned with the direction that they are now taking.

   In particular, we have concerns with the level of granularity that is being proposed and the potential to be driven towards a 'one size fits all' approach. We are very concerned that this development could stifle a DNO's ability to innovate and risks moving the DNOs

to a level of micro-management never before seen in GB regulation. This, in turn, adds a significant reporting burden on the DNOs and a significant audit burden on Ofgem. The need to report at the level of, say, transmission exit points (which are not part of the formal output measures), cannot be considered light touch regulation.

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

   We believe the increasing level of granularity that Ofgem is now seeking is at odds with the original goal of using output measures as the principal tool for demonstrating that the customer is getting value for money. We are supportive of a qualitative assessment of a DNO's performance at the end of the five year price control period, but we are very concerned that the proposed annual monitoring of a company's performance signals a move to rate of return regulation rather than the incentive based, light touch regulation that is characteristic of RPI-X.

   As noted in our response to the May methodology paper, we agree that the output measures should act as a trigger for Ofgem to challenge DNOs' spend at the end of DPCR5. However, this must be done at a high level rather than on an item-by-item basis. Counting 'widgets' will not drive improvements in efficiency or incentivise innovation to the benefit of all stakeholders. Such micro-management will not give customers the assurance that they are getting value for their money and is likely to lead to inefficient outcomes.

3. **What approach should be taken if we determine that a DNO has failed to deliver against its agreed DPCR5 outputs? Have we considered all reasonable options to impose financial consequences for under-performance?**

   We are not convinced that it is appropriate to outline options to penalise a DNO for underperformance. Whilst we accept that Ofgem should be able to use the output measures qualitatively to assess whether or not a DNO has underperformed, we do not believe that an *ex post* claw-back of, for example, IQI rewards is appropriate. Instead, the information should be used to inform the DPCR6 settlement and the level of opening RAV and capital programme going forward.

   If Ofgem is intent on enshrining the options for penalising DNOs that under-perform in a licence condition, we believe a regulatory impact assessment is essential. Such an impact assessment would be required well before Final Proposals to allow DNOs, and other interested parties, the time to comment.

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

   We believe there is merit in taking a lighter touch approach to output measures for those DNOs that have submitted accurate cost forecasts relative to Ofgem's internal assessment. DNOs faring well under the IQI mechanism have submitted robust forecasts

and it would therefore seem reasonable to apply a lighter-touch approach to their output measures.

CHAPTER 18: INNOVATION FUNDING INCENTIVE (IFI)

Key Message:-

§ **We support Ofgem's proposals in relation to the Innovation Funding Incentive (IFI) and believe that the proposals to develop a Low Carbon Network (LCN) fund will work well alongside this existing mechanism.**

1. **Do you agree with our proposal to retain IFI?**

   Yes. This has been an effective mechanism in DPCR4 and we see no reason why it should not continue to be effective in DPCR5. We believe the move to a flat pass-through rate across the period is sensible, and we welcome Ofgem's recognition of the need to retain flexibility in the use of the funding (i.e. to fund internal expenditure or third party work).

2. **Do you agree with our proposal to focus IFI on technical R&D, whilst creating the new low carbon network fund for the trialling of low carbon initiatives on the networks?**

   Yes. As commented earlier in our response, we strongly support the proposed LCN fund and believe this can be made to work well with the existing IFI mechanism. We agree that IFI should continue to focus on technical R&D, whilst allowing the new LCN fund to facilitate live network trials. Any guidance will need to clearly define the boundaries between the two, but we agree, in principle, with this approach.

CHAPTER 19: EQUALISING INCENTIVES AND THE INFORMATION QUALITY INCENTIVE

Key Messages:-

- **We remain fundamentally opposed to the proposal to equalise capital and operating expenditure incentives. We believe this is at odds with the stated objectives of incentivising DNOs to become more commercially aware and to take a greater role in preparing for the low carbon economy.**
- **Should this regime be imposed upon us, we consider the move to an 85:15 split between slow and fast money to be a positive step.**
- **We believe the Information Quality Incentive (IQI) has lost its strength as an incentive and now provides greater protection to those DNOs that have submitted less robust forecasts, than upside for those that have responded to the incentive. We believe Ofgem should correct this by applying an asymmetric approach and linking IQI performance to its application of output measures.**

We have continued to state our opposition to an equalised incentive approach on the basis that we do not believe this arrangement drives the right behaviour for the long-term health of the network. We continue to stand by this view. Once the allowance is set, an equalised approach drives the DNOs to minimise their investment over the short-term of a five-year price control. This is unlikely to drive lowest cost whole life solutions and is at odds with initiatives elsewhere in the price control to improve service levels to customers and to encourage innovation.

We are therefore very disappointed with the quality of the regulatory impact assessment (RIA) provided in Appendix 7. Upfront at paragraph 2, Ofgem states that the current rules have encouraged capex solutions over more opex-based solutions. This is simply incorrect. The current incentive rates may theoretically influence a DNO's decision in that manner, but it is not clear that this has happened in practice. Indeed, all DNOs have overspent against their opex allowances in DPCR4, whilst under-spending on capex.

In addition, we would challenge the assumption that the removal of the 'distortion' of incentives towards implementing capex solutions will lead the DNOs to implement solutions that minimise total lifetime costs. We agree that it will drive minimal investment during the five year period of the price control, but this must not be confused with total lifetime costs. We believe an equalised regime will drive the DNOs towards the *absolute* minimal investment to match statutory and licence obligations, with no discretionary spend on innovation, quality of service, losses or other such initiatives. Importantly, if capital and operating cost allowances are set at the appropriate level, DNOs will always seek to minimise lifetime costs; this is regardless of any steps to equalise the incentives on capex and opex.

At paragraph 1.6, again, we do not see how the proposal can lead to more efficient delivery of capex. In our view, the proposal will drive the DNOs to run their assets harder, at a time when significant investment is needed in the networks.

Finally, we do not believe that the proposal will result in DNOs considering more non-network solutions. We firmly believe it will drive DNOs to the cheapest solution within the narrow period of a five-year price control. Short-term 'quick and dirty' solutions do not necessarily support the UK's sustainable development strategy.

1. **Does the 85% capitalisation of all costs within the equalised incentive provide an appropriate speed of money?**

   We believe that in order to mitigate the incentive to under-invest under this new regime, Ofgem needs to maximise the share of totex that is subject to capitalisation. Notwithstanding our position on equalising incentives *per se,* we support the move by Ofgem in its Initial Proposals to increase the percentage from 80% to 85%. This goes a small way to reducing the instinctive behaviour brought about under the new regime to actively avoid non-statutory / discretionary investment. Whilst we continue to believe that, once the price control is set, any investment in capital is inefficient, this change in the capitalisation level means that for every £1.00 invested, £0.15 is wasted as opposed to £0.20 under the original proposals.

   As well as helping to reduce the tendency to avoid investment, we believe a higher capitalisation percentage, by reducing the allowed revenue across the period, will also help to relieve the pressure on the P_0 increases forecast for DPCR5.

   A further change that would help to mitigate some of our concers would be to fully expense certain indirect costs, such as customer call centres and health and safety and operational training.

2. **Does the IQI matrix presented provide an appropriate profile for the incentive strength? Should we be considering an alternative profile with a steeper incentive rate?**

   We have seen a clear reduction in the strength of the IQI in this price control.

   Having brought additional costs into the IQI mechanism in DPCR5 and therefore increased uncertainty, it is not clear why it was deemed appropriate to remove the 'uplift' that was built into the allowed expenditure in DPCR4.

   We are disappointed by the lack of reward for the work that was put into our submission to ensure that it was as robust and true to the future needs of our network as possible. We do not believe the matrix, as it stands, suitably recognises this and, arguably, the new approach rewards those that might be tempted to submit an inflated forecast, which

factors in some element of out-performance and an element of protection in the event of any overspend.

For the IQI to work alongside output measures and to continue to drive efficient forecasting, we believe it needs to move to an asymmetric basis. At the left hand side of the matrix, we believe the potential upside should outweigh the potential downside, whilst at the far right hand side of the matrix, the emphasis should be on the downside risk. This would be a strong incentive on the DNOs to focus on their forecasting accuracy, and certainly more effective than the alternative matrix currently presented in Figure 19.3.

As discussed earlier, there is perhaps also scope to grade the level of commitment required under output measures based upon IQI performance. It does not seem unreasonable that DNOs performing well under the IQI should expect to see a lighter-touch / higher level approach in terms of their output measures as a way of rewarding the submission of robust business plans.

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

As noted in our response to Q2 above, the Initial Proposals impose a clear reduction in the IQI incentive strength. We therefore consider that it would be completely inappropriate to further adjust the additional income line as suggested.

Indeed, Ofgem's assessment is with regard to a DNO that achieves the 50% incentive rate; currently, no DNO has met this. It seems to us incorrect to claim that the 30% to 50% proposed by Ofgem moves the incentive strength closer to the DPCR4 weighted average incentive strength on network related costs when no DNO is at the top end.

94/09

Key Messages:-

- **We are extremely disappointed with the changes that have been introduced to Ofgem's approach in assessing and setting costs.**
  - **The move to separately benchmark direct and indirect costs provides inconsistent results with all previous regressions and adversely impacts the allowed revenue of both of our DNOs, which have consistently been shown to be the most efficient overall.**
  - **Ofgem's assessment of unit costs appears to be arbitrary and will stop us from delivering the volumes that we (and Ofgem) believe are necessary.**
- **Ofgem's proposal to set efficient DNOs' allowances on upper quartile costs, whilst basing poor performing DNOs' allowances on average costs is completely unacceptable. All DNOs' cost allowances must be based upon a single efficiency line. If not the average, then a common line between the average and the upper quartile should be set.**
- **Any methodology that shows a company to be at the frontier for one set of costs and ninth for another is clearly wrong. We believe Ofgem needs to revert back to a combined benchmarking approach to set allowances.**
- **Going forward, we would appreciate DNO-specific appendices as part of both the autumn update and Final Proposals to ensure that we are able to more readily recreate and understand Ofgem's analysis of both capex and opex.**

CHAPTER 1: OVERVIEW OF OUR APPROACH TO COST ASSESSMENT

1. Have we taken an appropriate approach to assessing costs?

Over this review period, we have generally been supportive of Ofgem's approach to both benchmarking and network investment costs. However, this latest iteration, as put forward in the Initial Proposals, has raised some serious concerns. We have written separately to Ofgem on these points to raise awareness as early in the process as possible. For completeness, we have included our key concerns below.

<u>Operating Cost Assessment</u>

The proposal to set allowances on a disaggregated basis has unfairly disadvantaged DNOs that have a strategy of insourcing. Ofgem itself recognises this in paragraph 4.44 of 94/09. In addition, despite efforts as part of the RRP process, we believe some indirect costs are being reported within load and non-load capex. We report these costs as indirect costs as required by the RRP rules. This accentuates our concern on indirects. Again,

Ofgem is aware of these inconsistencies and we welcome its efforts to adjust for this ahead of the autumn update. To this end, we strongly support the recent request from Ofgem to submit more detailed contractor costs.

Whilst we believe this concern is best corrected by Ofgem taking an aggregated allowance-setting approach, i.e. by assessing both indirects and network operating costs together thereby removing any boundary issues, we believe this detailed information will at least allow Ofgem to make the appropriate adjustments to its current analysis, should it continue to apply this approach.

In Ofgem's May Methodology Paper, the relative efficiencies and rankings of the DNOs were consistent regardless of the cost drivers and methodologies used. The proposed move to now set allowances on separate benchmarks for network operating costs (NOC) and indirect costs has resulted in serious inconsistencies. In all previous comparative analysis work, SHEPD has been identified as the frontier or second best performing company overall. However, SHEPD is now ranked frontier for NOCs, but ninth for indirects. It is clear to us that despite Ofgem's best endeavours during the RRP process, boundary issues still exist in trying to allocate these costs. As such, we believe the only practical option is to carry out a combined NOC and indirect cost efficiency analysis to set baseline allowances. To do otherwise penalises one of the best performing DNOs (whilst rewarding some of the worst). SHEPD, for example, has had £34 m removed from its DPCR5 forecast despite being ranked second overall. This equates to 12% of its 2008/09 actual costs.

Also on Ofgem's regression analysis, we fundamentally disagree with the inconsistent approach to setting allowances on the basis of both an average efficiency line and the upper quartile. This rewards inefficient DNOs by factoring in out-performance and fails to adequately reward frontier companies. This approach is also inconsistent. Historically, Ofgem has used the upper quartile or average to both incentivise the leaders and reflect possible issues with the data, but to the extent that such data issues still exist, they should apply to all DNOs, not just the laggards. We believe Ofgem should adopt a consistent approach and bring all DNOs for all operating cost categories to the average efficiency line. Whilst intellectually correct, we recognise that this may not be achievable in one step. As a minimum, we therefore propose that Ofgem establishes an intermediate point between the upper quartile and average performance, and that all DNOs are brought to that line.

The other key area for us is the assumed relationship between capex and indirect costs. We experienced a slow start to our DPCR4 capex programme. During the period, our indirect resource was built up in order to deliver the levels of capex required to meet our programme. This included a number of large reinforcement and refurbishment schemes. As such, our capex dips slightly in the first year of DPCR5 relative to 2009/10 levels. This reduction, and Ofgem's assumed link between capex and indirects, results in SEPD's

indirect expenditure being cut by c.£10 m across DPCR5. It has taken four years to achieve our current level of indirects and this proposed cut equates to a reduction of c. 40 indirect staff. This cannot be right for the frontier company.

In addition to these key areas, we have identified further errors and omissions in the calculation of the baseline allowances in the Initial Proposals. We would expect these errors, which include the calculation of inspection and maintenance costs associated with island diesel generation costs, and the omission of any allowance for vehicle and non-operational capex costs associated with direct capital activities, to be amended ahead of the autumn update.

If, following all these changes, Ofgem's regression analysis still throws up unexpected and unexplained results, we believe this brings into question the functional form of Ofgem's regression analysis.

Capital Expenditure Assessment

There is a widespread issue on the unit costs that have been applied by Ofgem. Again, we do not believe that we are alone in this concern. We simply cannot deliver the volumes proposed by us and approved by Ofgem at the unit costs set out in the Initial Proposals.

Specifically, we have focused on two key areas: (i) our Consac replacement programme; and (ii) our HV overhead line refurbishment plan. However, we believe all the reductions Ofgem has applied warrant review.

Our unit rate for our Consac programme was robustly derived. By its very nature, it is a more expensive programme, and the laying of LV mains cables for other programmes, for example, replacing overhead line, cannot be used as a proxy. Ofgem must therefore derive costs for our Consac programme based upon the specific costs submitted.

On HV overhead line refurbishment, we have seen a considerable reduction in our proposed costs and can only assume that this is down to Ofgem rejecting our decision to use BLX. Ofgem's assessment has focused on our decision to use BLX, which we have used for the last ten years. It has overlooked the fact that we have reduced our overall HV overhead refurbishment costs by 15%. Our self-imposed efficiency improvements have been further penalised by a 15% reduction in our baseline.

We have expressed a clear concern during this process that the level of data granularity being sought is driving a high level of estimation. This concern has been realised in the Initial Proposals with Ofgem using this data to micro-manage our investment decisions. BLX has proven itself as a core element of our investment strategy and we would strongly oppose any push back from Ofgem in continuing to use BLX in DPCR5.

Separate to all of the above, there is a more general point surrounding Ofgem's analysis. We have been unable to recreate several aspects of Ofgem's analysis and do not believe that we are alone in this. In the autumn update and as part of the Final Proposals, we would very much welcome a clear appendix for each DNO allowing them to be able to reconcile their allowance from the relevant inputs. This applies at a high level as well as some of the more detailed tables and applies to both Ofgem's operating cost assessment and network investment.

2. What mechanism should be used to fund high value projects?

We believe Ofgem should provide an *ex ante* allowance in line with company projections for high value projects. It is not appropriate to adopt a 'logging-up' mechanism for high value projects.

3. What assumptions do you think we should use for real price effects and ongoing efficiencies for DNOs over the 2010-15 period?

We believe the recession has clearly had an impact on input prices, and the work carried out by First Economics, on behalf of the DNOs, supports this. First Economics has prepared an update note on the rate of wage inflation that explains why it believes Ofgem has understated the labour cost pressures that DNOs will face during the next price control period. One concern is that Ofgem has not allowed any sort of differential wage inflation for skilled infrastructure specialists. In addition, Ofgem's assumption of average earnings growth in the steady state is at odds with historical experience.

Based on the work carried out by First Economics (including the latest update), we believe that our forecast of real price effects in our FBPQ submission remains valid.

Given the ongoing uncertainty in this area, we have previously suggested that DNOs are allowed their forecast increase in input prices; with the option for review, should a defined trigger be met. We continue to believe that this is a sensible way forward.

In terms of ongoing efficiencies, we note that Ofgem has proposed an efficiency factor of 1% p.a. based upon information provided by WPD. However, we understand from recent discussions at an Ofgem / ENA cost allowance group that this proposal has been misinterpreted and that WPD's efficiency assumption is in fact lower. As the most efficient DNO, we have driven costs down by 50% over the last 20 years. We believe the next major step change will come from delivering a more dynamic network as we move towards a reduced carbon economy. Until then, we firmly believe a 0.5% p.a. frontier shift is a more realistic and reasonable target.

Finally, we believe any efficiency improvements as set out above should be built in from 2010/11 onwards, and not before.

4. **Do you agree with our proposed methods for handling uncertainty?**
   Uncertainty is inherent in any price control and we believe care is needed to identify only those areas where there is significant uncertainty beyond 'business as usual'.

   We have already outlined our proposed mechanism to address input price risk. We believe the uncertainty surrounding input prices is greater going into DPCR5 than it has been at previous price controls. We do not agree with Ofgem's position that *"the IQI sharing factor provides enough protection"* against this. Arguably, this has increased the exposure relative to previous price controls given that the incentive rates under this mechanism have increased.

   In addition, this mechanism has the perverse incentive of placing greatest exposure in terms of input price risk on those DNOs that submitted the most robust forecasts. This does not seem appropriate and we would urge Ofgem to revisit how this risk sharing mechanism works in DCPR5.

   The remaining changes proposed seem reasonable. One noticeable exception is the unique position on Shetland and the need to re-power the island during DPCR5 / DPCR6. At this stage, the replacement solution for the island is unclear. It is therefore not feasible to design a mechanism to deal with these costs ahead of finalising DPCR5. As such, we believe this will have to be addressed through a re-opener mechanism.

5. **Are our proposals for volume drivers on low-cost connections involving shared assets proportionate, i.e. is the mechanism necessary?**
   We believe Ofgem's proposal for high volume, low cost connections is reasonable, providing the unit cost applied during the price control period is at an acceptable level.

6. **What is an appropriate materiality threshold for the operation of our proposed load related expenditure reopener?**
   We support, in principle, Ofgem's proposed approach to managing uncertainty in relation to load-related expenditure associated with general reinforcement and the shared element of low volume, high cost connections.

   Key to this mechanism will be ensuring that efficiency improvements are still recognised and rewarded, i.e. that these savings do not mask genuine increases in costs. To this end, we believe the approach, as set out by Ofgem, is pragmatic, but would benefit from a truing up of the load forecast (i.e. MWs added) against actuals. This would reduce the influence of factors outside the DNOs' control, whilst retaining the incentive for accurate costing and efficiency. We would also suggest that the range of innovative solutions qualifying as efficient spend is widened to include storage, dynamic line rating, contracted generation, demand-side management, etc. We believe this ensures consistency with steps elsewhere in the package to drive forward innovation.

As part of this, we believe that there needs to be clear and upfront guidance in relation to the conditions that activate the trigger and the level of evidence required to instigate a re-opener.

Finally, in terms of the proposed symmetrical re-opener, we believe this is an appropriate approach. However, this is only symmetrical if Ofgem assumes a baseline allowance equal to, or very close to, our submitted forecast. A baseline below our forecast, effectively creates an asymmetric mechanism, with a higher degree of downside risk for the DNO, which we would find unacceptable.

7. **Does the GDPCR reopener for TMA costs provide a good template for our final DPCR5 proposals for these costs?**

   We welcome Ofgem's proposal to give SEPD (and the EDF companies) some allowed costs for TMA charges. The TMA schemes are starting off in the London and Kent areas and it is appropriate that the DNOs most affected are given appropriate allowances. However, we are concerned by two main aspects of Ofgem's proposal and these are noted below.

   We understand why Ofgem has benchmarked the unit permit costs and the assumptions on penalties, and agree that this is required to ensure allowances fairly reflect what the companies actually require. However, it would be inappropriate to assume that different Councils will apply these schemes in the same way and with the same cost structure. It is therefore not appropriate to benchmark across Council areas and we believe Ofgem should only consider benchmarking Council charges to DNOs who operate in parts of the same Council territory. In any case, the costs so far submitted are a small fraction of future costs and are only ever likely to increase going forward. The costs Councils charge will be a matter of public record and will be available for checking (and subject to verification at the annual RRP visits).

   The level of penalties will largely be governed by the efficiency of processes employed by individual DNOs. It would be inappropriate for Ofgem to allow different DNOs different penalty percentages. We suggest Ofgem takes a view on an appropriate level based on its knowledge of DNO efficiency and makes allowances that acknowledge the efficient companies whilst allowing appropriate costs to the others.

   Ofgem makes reference to a great deal of confusion in respect of DNO FBPQ submissions and answers to questions. This issue is complicated, currently ill-defined and difficult to explain in writing. We suggest Ofgem convenes an early meeting of DNO TMA experts to discuss with Ofgem and share understanding.

   In respect of Ofgem's proposal to use the GDPCR template for the DPCR5 Final Proposals, we agree that this forms a reasonable basis for doing this.

CHAPTER 5: SUPPLY ON SHETLAND

We welcome Ofgem's recognition of the need to continue to apply the mechanism to meet the costs of the existing arrangements on Shetland.

Further to that, we have worked closely with Ofgem to seek an efficient, enduring solution for securing supply on the island. Whilst we are not opposed to a competitive tender process, we are aware of the possible negative perceptions of SHEPD running the tender. Given this, if Ofgem is intent on progressing this option, it may be better for the tender to be run by a third party (perhaps NGT in its role as the GB System Operator) as a 'turnkey' project including tendering for the role of Distribution System Operator.

However, we do not believe that such a tender process is necessary or desirable. In our view, incentivising SHEPD to develop an integrated, whole island solution will not only provide immediate clarity, but will also involve market-based solutions. We will need to access the market, through tenders as appropriate, to identify and procure demand-side options, such as storage devices, as well as the conventional generation assets. Furthermore, we would seek the involvement of suppliers, manufacturers and the island community regarding options such as district heating and the installation of heat pumps. There is a risk that a defined tender to, for example, provide a power station will be the "wrong choice" for Shetland as a whole, compared to a package of measures including such a power station.

95/09

Key Messages:-

- **The cost of capital is the return required by investors in a business. It is completely inappropriate for the baseline rate of return for an efficient and well-performing DNO to be set below the WACC. The price control settlement must include scope for an efficient DNO to outperform the WACC.**
- **PwC's assessment of the WACC is completely inappropriate. It is not plausible that the WACC for DPCR5 could be significantly lower than the DPCR4 rate given the economic uncertainty. We believe NERA's range of between 4.6% and 5.4% post tax real to be more realistic.**
- **We do not believe a mechanism is required to deal with uncertainty in the cost of debt.**
- **We do not agree with DNO-specific RAV additions percentages.**
- **We fundamentally disagree with the proposal to allocate allowable expenditure to capital allowances pools on an average basis. This needs to done on a company-specific basis.**
- **We remain supportive of an appropriate tax trigger for material changes to a DNO's cashflow.**

CHAPTER 1: COST OF CAPITAL

1. **Do respondents think that PwC have identified an appropriate range for setting the cost of capital?**

   In answering this question, it is first necessary to be clear on what would constitute an "appropriate" level of allowed cost of capital. The cost of capital is the return required by investors. Our continuing enthusiasm for, and investment in, electricity distribution is predicated on our ability to:

   (i) Cover the costs associated with the efficient operation, maintenance and expansion of the networks; and

   (ii) Earn returns that are commensurate with our position as a leading DNO, based on our ability to outperform.

   We are therefore concerned by Ofgem's suggestion that its *"approach to cost assessment already means that the "baseline" rate of return of most companies will be below the assumed rate of return in WACC"* (92/09, paragraph 4.7).

   In spite of the issues associated with measuring the cost of debt and equity underpinning the allowed cost of capital, it is critical that these costs are recognised to be real costs that

must be met by a DNO. If there is insufficient allowance made for these costs, then investors will not commit their capital to the sector.

This logic applies equally to our internal investment decisions, whereby our Board has a fiduciary duty to allocate our finite resources so as to target an optimal balance of risk and return. Again, if the available returns from investing in electricity distribution networks are unattractive, either in absolute or relative terms, then continued investment in the networks would be inconsistent with these aforementioned duties.

We believe it is especially important to consider these fundamental issues now, given the combination of the significant infrastructure investment challenge, not just in GB but globally, and the current economic instability, which has led to a substantial increase in the pricing of risk and has constrained capital at a time when it is needed most. Setting the cost of capital at an "appropriate" level is therefore arguably even more sensitive an issue than would normally be the case.

In seeking to form our view of the "appropriate" level, we have worked extensively with NERA and other DNOs to assess the basic building blocks underpinning the cost of capital. We believe that the approach taken in balancing costs associated with the long-run with those associated with the current financial crisis, is robust and we have already shared the results of this work with Ofgem. In addition, we have worked with NERA, and other DNOs to assess the approach adopted by PwC and the appropriateness of its proposed range. Again, we have shared the findings of this work with Ofgem and the principal conclusion that only the very top end of PwC's range approaches what could be regarded as an "appropriate" level. We do not propose to repeat all of the detailed criticisms here, but we are compelled to highlight the following key points:

§ PwC's WACC analysis appears to take no account of the recession and credit crisis;
§ While encompassing Ofgem's final decision at DPCR4, the overall PwC post-tax WACC range of 2.9% to 5.1% offers substantially more variation to the downside than the upside of the DPCR4 figure of 4.8%. Given the extraordinary turmoil in financial markets since mid-2007, it is not plausible that the WACC for DPCR5 should be significantly lower than the WACC for DPCR4; and
§ PwC's cost of equity range appears to have been derived by simply combining plausible ranges for each of the CAPM parameters with little regard to the internal consistency of the overall CAPM results, and with no cross checks against other market evidence (e.g. DGM, transaction evidence etc).

As indicated above, we agree with the results of the analysis conducted by NERA and we view an "appropriate" range for the post-tax real cost of capital to be 4.6% to 5.4%, equivalent to a vanilla WACC of 5.2% to 6.0%. If, as the frontier DNO, we are to earn at least 5.5% post-tax real, then the final number, from within this range, will depend on the incentives available to outperform.

The Initial Proposals make explicit links between the allowance for pension cost recovery, the proposed tax trigger mechanism and the allowed cost of capital. Whilst we recognise that Ofgem has not yet provided the detail required to assess this linkage, we are concerned by the potential significance that Ofgem is attributing to this link to the allowed cost of capital. The reality is that the unavoidable risks facing DNOs during the next price control period in relation to both pensions and tax are significantly higher than previously, and therefore Ofgem would purely be realigning this risk to that present in DPCR4, i.e. this aligns the future risk level with the current position. This should not be confused with an absolute reduction in the risk facing the DNOs. Our concern is that the quantification of these risks, and attempts to translate them into basis points on the WACC, will inevitably be flawed and may increase the current delta between the range proposed by PwC, and that which we regard to be "appropriate".

2. **How should we balance our standard long-term view of the cost of capital with current indicators in the capital markets?**

We welcome Ofgem's statement that it *"… will balance [the weight applied to long term evidence] with consideration of the need to finance substantial incremental investment and the possibility that, in the near term at least, new finance may only be available at rates higher than those suggested by long-term historical evidence"*.

We advocate the approach adopted in the analysis we have carried out with NERA and the other DNOs. This is based on an explicit recognition that current conditions do not accord with long-run averages and hence must be given an appropriate weighting in assessing an "appropriate" level of cost of capital. For the avoidance of doubt, we do not believe that current and historically volatile conditions have been given due recognition in PwC's analysis.

The key questions to be answered, in relation to the next price control period, are:

- What is the current cost of capital?
- When will the cost of capital change?
- What will the revised cost of capital be?

These questions are addressed in detail in NERA's report of June 2009, which was shared with Ofgem at that time.

Analysis of various economic forecasts led to the conclusion that a 50:50 weighting between current and historic conditions, and hence the relevant cost of capital levels, would be an "appropriate" scenario on which to base an assessment of the cost of capital.

3. **Which, if any, of the alternative methods of dealing with variability in the cost of debt should we adopt?**

We believe the status quo should be retained.

4. **What are the pros and cons of the mechanistic debt trigger as suggested by PwC?**

Our strong preference would be to maintain the status quo in relation to setting the cost of debt – i.e. it should be set as part of the price control review for the whole of the price control period, without any mechanistic trigger to reset it.

We believe that the introduction of a mechanistic debt trigger would have the following issues:

§ Interfering with management's ability to optimise the capital structure: a trigger mechanism may impact the incentives on DNOs, with the choice of benchmark measure directly affecting the way in which companies finance themselves.
  A risk-averse company might match the timing and structure of their debt closely to the benchmark measure, for example - distorting incentives to use more innovative, and potentially lower cost, methods of financing. The strongest incentive to minimise the cost of capital is achieved by setting an "appropriate" level at the time of the price control and then allowing management to seek to outperform it;

§ If the benchmark relied on using index-linked gilt (ILG) yields as the basis for a real risk-free rate, the volatile and biased nature of ILG yields would also be a concern: changes in ILG yields related to macroeconomic policies, such as quantitative easing or to technical market factors like illiquidity or shortages, may lead to mechanisms being triggered even when the "true" underlying risk-free rate has not changed;

§ Imposing a trigger framework would inevitably be complex, increase the potential for unintended consequences and potentially be costly to implement and monitor; and

§ Potentially distorting the assessment of what would be regarded as an appropriate cost of capital at the time of the price control, with inappropriate reliance being placed on a cumbersome mechanism.

CHAPTER 2: REGULATORY ASSET VALUES

1. **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?**

By its very nature, a totex-based approach reduces the boundary issues relative to the more disaggregated approach that has been applied to RAV additions in all previous price controls.

We do, however, believe that there may be merit in moving certain costs that currently sit in network indirect costs into business support, for example, customer call centre costs and health and safety and operational training.

2. **In what circumstances would you consider it appropriate to have DNO-specific RAV additions percentages?**
   We do not believe this is appropriate and would strongly oppose any proposal to implement DNO-specific RAV addition percentages. We believe that it is important that stakeholders can clearly understand the RAV additions principles applied across the DNOs.

CHAPTER 3: EXCLUDED SERVICES

1. **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 paragraphs 3.9 to 3.19 above)?**
   Yes, we believe it is now appropriate to bring these three areas within the main price control.

2. **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?**
   Having separated out metering activities in 2007/08 and set up SSE Metering Ltd., all metering activities (except legacy meter asset provision) have been transferred to that business. For DPCR5, we would expect SSE Metering Ltd to offer a revenue protection service, on a commercial basis, to all suppliers that wish to contract for the service. We have no intention of offering this service through our DNO businesses.

CHAPTER 4: CORPORATION TAX ALLOWANCES

1. **Do you agree with our position on the tax methodology?**
   We broadly agree with the overall tax methodology, but fundamentally disagree with the proposed application of attributing allowable expenditure to capital allowances pools by averaging the common approach. We are strongly of the opinion that the expenditure should be allocated on a company-specific basis.

   We do not believe that applying an average would result in individual DNO's tax positions being fairly reflected. Instead, we believe it will distort the tax position for individual DNOs. The regulatory model should seek to assess the individual DNO's tax liability that will be cash settled with HMRC, and the use of a common approach may result in material divergence from an individual DNO's capital allowances and hence tax position. The following sets out the reasons as to why we believe a common approach may result in a material divergence from an individual DNO's capital allowances:

- Capital expenditure for an individual DNO on a particularly large project may result in that DNO being an outlier from the average. This could materially advantage or disadvantage that DNO; and
- The allocation methodology for specific DNOs may be subject to agreement or an accepted methodology with HMRC. HMRC requires each DNO to substantiate their allocation to capital allowance pools by that company's detailed project analysis and industry averages have no part in this process;

We therefore, do not agree with Ofgem's reasoning that *"using a common approach has merit in that it aligns the tax treatment of all DNOs' cost categories and follows the consistent approach of applying the same treatment to each element of costs making up the overall revenue allowance, e.g. as WACC, debt, pensions across licensees"*. It is important to recognise that the allocation of capital expenditure to capital allowances pools is governed by legislation and DNOs do not have the flexibility to adjust tax attributes in the way that they are able to adjust, for example, gearing. It is a DNO's capital expenditure programme that drives the tax allocation and not the tax allocations of the other DNOs. The methodology must therefore adopt a company-specific approach to recognise this.

The use of a generic as opposed to a specific approach in DPCR4 has resulted in actual capital allowances pools being very different from those used in the DPCR4 model. Taking tax written down values from the latest tax returns as the opening values for DPCR5 will therefore result in expenditure either being double-counted or not being counted at all. This inconsistency in treatment can have a significant impact on a DNO's allowed revenue and it is essential that this is recognised. We believe that it is correct to use opening tax written down values based upon the latest submitted returns, a one-off adjustment is required to correct the differences caused by the methodology used in DPCR4. In order to avoid this problem recurring at the end of DPCR5, the specific tax allocations of each DNO should be used as the basis for allocating capital expenditure to the pools in DPCR5.

2. **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 that there should be a tax trigger mechanism if appropriate criteria are met. We share the view that the trigger mechanism should apply to material changes to DNOs' cashflows that can be separately measurable and can be discretely modelled by Ofgem. However, we believe that the proposed tax trigger mechanism should be widened to not only include legislative changes, but also to include changes in tax law, changes to HMRC interpretation of tax law and changes to accounting standards. Any of these changes that arise during the price control should be considered on a case by case basis and would only trigger a change to the price control allowance if material, separately measurable and capable of being discretely modelled by Ofgem.

We do not agree that the introduction of the trigger mechanism should be reflected in the cost of capital. We are of the view that the current political and economic environment presents an increased risk of major changes to the tax framework in DPCR5. The tax trigger mechanism merely mitigates this new risk. We therefore believe that Ofgem should either reflect this additional risk by increasing the cost of capital, or by introducing the tax trigger mechanism leaving the baseline cost of capital unchanged. Such a trigger mechanism is symmetrical. As such, the DNO is exposed to both positive and negative tax changes. We therefore do not believe that it is appropriate to try to reflect this in the baseline cost of capital.

We agree that there should be a minimum threshold for the trigger mechanism and that any adjustments required should be on the whole amount associated with the trigger event and not the excess amount over the threshold. In setting the threshold, we believe that a 1% change to corporation tax rates should be regarded as a material change. We are of the view that the threshold should therefore be set at a level of between 0.25% and 0.5% of price control revenue. This would ensure that consideration of less significant changes are avoided, but changes with a material impact are recognised.

CHAPTER 6: REVENUE ALLOWANCES AND FINANCIAL MODELLING

1. **Do respondents agree that we have appropriately identified the scope of the price control, i.e. are we making allowances for the right categories of costs?**

   In our view, the scope and structure of the price control is broadly correct. However, there are a few points that we would like to be make on the allowances as they stand:

   (i) We do not believe adequate operating costs have been allowed for our two network businesses, which, on overall efficiency, have been shown to be first and second;

   (ii) We do not believe that adequate costs have been allowed for the outputs proposed in our FBPQ submission;

   (iii) We do not believe there is scope for out-performance in the current proposals; and

   (iv) We do not believe that the incentive package currently proposed will allow the DNOs to take an active role in meeting the Government's 2020 carbon commitments.

   Overall we do not believe that the proposed package will drive the behaviours sought by Ofgem, and we are concerned that this is a missed opportunity.

   More detailed points are:

   - There is no mention of a separate price control for metering in the Initial Proposals. This is a serious concern as all DNOs continue to own legacy meters and require to recover the meter asset provider (MAP) costs over the next price control period;
   - The pass through costs in paragraph 6.6 need to include the Shetland term for SHEPD;

- We believe that Ofgem should specifically target at least an A- credit rating with their financeability tests;
- We believe the modelled change to SHEPD (and Scottish Power Distribution) depreciation profiles is incorrect. The change should apply from 2010/11 onwards, and not 2011/12; and
- Furthermore, the modelled capex roller for the two Scottish DNOs is incorrect as it currently sets the depreciation factors at 1/20 during DPCR4 rather than the correct 1/38.

2. **How do respondents think we should profile allowed revenues over the 2010-15 period?**

   Notwithstanding the need to adjust the two Scottish companies' depreciation profiles, we do not believe that profiling of revenues is necessary. As per DPCR4, as long as the financeability tests have been passed we see no reason to profile revenues.