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Dear Rachel

The Initial Proposals published in August 2009 contained several areas of costs which, for various reasons, Ofgem was unable to put forward a view of an appropriate allowance. Your September Update letter now details proposals for the treatment of these costs. Our specific responses to your proposals are contained in the appendices, but the main points of our response I would like to set out here.

Demand connections volume driver

We support the principle of a volume driver but have significant concerns about the way in which unit costs have been derived. More representative unit costs must be established in advance of Final Proposals.

Logging up/Reopener combination for HILP, CNI and Black Start

Government departments are essentially the drivers for this expenditure. It would seem that it is in all customers' best interest that the electricity network is resilient in the face of identified adverse circumstances and that an ex ante allowance is appropriate. Ofgem's proposal to allow 95% of efficient CNI costs is absurd; all legitimate efficient business costs should be allowed.

Reopener combining Low Volume High Cost connections and general reinforcement

We do not support a combined reopener for these two categories,



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but suggest two separate reopeners. We suggest that a percentage of allowance threshold is appropriate for the LVHC trigger, but due to the more material allowance that a small percentage of allowed base revenue is an appropriate general reinforcement trigger. The proposed trigger level of 20% of baseline allowance is too high.

I note that a further joint meeting is proposed to discuss the introduction of an incentive scheme for Transmission Exit Charges. This is important as the present proposal introduces unnecessary risks for customers and shareholders alike. Please do not hesitate to contact me if you wish to clarify any of the topics raised in this response.

Yours sincerely



REGULATION MANAGER

Network cost assessment (Appendix 1)

Question 1: Do you consider the volume drivers proposed for customer demand connections to be appropriate?

While we support the principle of the volume driver we have concerns about the inconsistent way in which DNOs have provided unit cost data. The range of costs and volumes imply different assumptions, which was further illustrated by the discussions during the Ofgem-DNO conference call on 8th October. We anticipate that some of these inconsistencies will be resolved for final proposals leading to more representative benchmark costs.

Our experience illustrates that the complexity of work and therefore associated costs for LV connections with HV work can vary significantly. So whilst improved data can lead to better benchmarks, the actual costs could be significantly higher for the same or lower volumes, leading to a shortfall in allowances. This can also be the case for the other two categories of LV connections requiring shared-cost LV only work and these are not necessarily homogeneous as you describe in the update.

The exercise undertaken by DNOs to split out the connections volumes and costs into the necessary subcategories has required a level of assumptions for forecasts based on samples of historic data. This basis for the forecasting could mean that outturns in DPCR5 could vary by a substantial amount at this subcategory level. When tied in to unit cost volume drivers this could represent a risk for DNOs which could be balanced by a modification to the proposed volume driver.

We propose a modification to the purely mechanistic nature of the volume driver and request that Ofgem includes the opportunity for DNOs to recover additional costs (over the benchmarked unit prices) where they can demonstrate that they have installed connections of a more complex nature.

Question 2: Do you consider the proposed reopener for low volume, high cost connections and general reinforcement appropriate? Is it set at the right level?

We have concerns about combining low volume, high cost connections with general reinforcement within a single re-opener. There are a number of factors that lead to a preference for the connections and general reinforcement elements to be determined under separate re-openers.

There are three main scenarios that drive the separation of connections from general reinforcement:

1. The costs of low volume high cost schemes can vary significantly particularly where 132kV reinforcement is required. Therefore volumes may not change but the mix and complexity of schemes can lead to large variations in reinforcement requirements and subsequent cost.
2. There is a possibility with the economic recovery that the volumes of LVHC connections could rise above those within our forecasts.
3. The stimulation of competition within High Volume Low Cost connections could lead to a greater volume of ICP and IDNO connections where DNOs would not be credited with the LV volumes, but would still require to carry out network reinforcement (under LVHC expenditure). The absence of the volume credit would mean that, under the proposed volume driver for HVLC connections, DNOs would suffer reductions in upstream reinforcement allowances following period-end true up.

The proposed connections/general reinforcement re-opener mechanism only allows cost recovery for 20% variances to the total of both allowances. Since in most cases the general reinforcement allowance is significantly greater than the new connection reinforcement allowance, a disproportionate volume of extra new connections is required to trigger the re-opener if there is no variation in general reinforcement. For example, assume the general reinforcement allowance is £200m and LVHC connection allowances are £50m, giving a combined allowance of

£250m; to qualify for a re-opener (assuming 20% trigger) the additional expenditure would need to be an extra £50m (i.e. double the connections allowance assuming no change to general reinforcement). This seems to introduce a disproportionate risk into upstream reinforcement costs associated with LVHC new connections.

We urge Ofgem to consider implementing two separate re-openers: one for LVHC new connections and the other for general reinforcement.

While a percentage of baseline would be acceptable for LVHC new connections because of their relatively low total value, a 20% threshold for a much larger, general reinforcement programme could pose significant funding issues for some DNOs. In order to ensure that DNOs would be able to fund the additional expenditure up to the trigger we consider that a threshold based on 1% of revenue would be more appropriate than one based on the programme value and would align, in principle, with the trigger for ESOCR work.

In addition, where DNOs have forecast general reinforcement activity greater than that allowed by Ofgem's allowance it seems perverse that the shareholders should be penalised on the basis of Ofgem's view rather than the DNO's. Clearly there is a significant degree of uncertainty in both Ofgem's and the DNOs' forecasts but to mitigate the effect of this unfairness we consider that, in addition to the mid period re-opener suggested, the DNOs should be able to initiate a truing up of allowances at the end of the period based on the actual activity undertaken.

Question 3: Do you agree with the proposed mechanisms (re-openers/logging-up) for dealing with uncertain costs?

While we accept that re-openers are appropriate for low volume high cost connections and general reinforcement as a consequence of the uncertainty of the speed of economic recovery, we are surprised that Ofgem is considering a logging up and re-opener mechanism for investment in HILP, CNI security and Black Start, particularly as this is being driven by government

departments. This introduces unnecessary additional regulatory burden for DNOs and costs for Ofgem.

The absence of historical cost information and uncertainty about the final policy decisions for these activities should not preclude ex-ante allowances. The absence of ex-ante allowances provides very limited assurance to shareholders that efficiently incurred costs will be recovered, which is further compounded by the proposals that only 95% of CNI costs will be recoverable (affecting even the most efficient DNOs). This introduces risk into the DPCR 5 deal and potentially discourages investment that is viewed as important by government bodies.

For HILP, Ofgem has suggested that the customers within the Central Business Districts should be approached to fund the work or chose to adopt their own equivalent proposal. While the individual customers may well benefit from the proposals, the driver for this work is the effect that a major loss of supply would have across the whole of the UK economy and, as such, the cost should also be borne by society in general. The most likely outcome, where some customers agree to provide funding, others adopting their own solutions and the remainder disputing the need at all, would result in wasted expenditure and a solution which would not meet the original objectives.

We propose that the logging up and combined re-opener is replaced with ex-ante allowances in line with forecasts, with protection for customers being given by ex-post true ups of volumes and costs as part of the DPCR6 assessment process.

With regard to the discretionary allowance proposed for WPD, we are not in a position to evaluate the benefit obtained by providing financing outside the proposed LCN fund but, if such an ex-ante allowance is made, the obligations on WPD for sharing of information should be applied as if the project were being financed through the LCN fund.

Question 4: Do you agree with our proposed methodology for setting flooding expenditure allowances for DPCR5?

In our view the proposed methodology for setting flooding expenditure allowances is appropriate.

Network investment policy (Appendix 2)

Question 1: Do you consider our proposals for an application window to be appropriate?

While we appreciate that having a re-opener window allows Ofgem to carry out comparative cost benchmarking and reduces the amount of time spent evaluating requests, restricting all re-openers to the same point in time introduces difficulties for DNOs to have sufficient evidence to support re-opener claims. This particularly applies to the load related re-opener where by March 2012, there would have only been two full years of DPCR5 load growth and connection volumes to compare with final baseline allowances. Applying for a re-opener would require forecasting of three years of investment (including connections volumes) which would make the assessment of volumes and efficient spend somewhat subjective. We suggest that a second re-opener window is opened in March 2013 to allow a more representative case to be put forward for load related investment.

In addition, as described previously, we consider that a truing up mechanism for general reinforcement, triggered by DNOs, should be available at the end of the period.

Logged up uncertain costs (assuming this policy approach continues) require a realistic trigger to be set to enable assessment in March 2012. This should be set at 2/5ths of the total forecasts, such that where expenditure is in line with DNOs proposals, DNOs have the opportunity to demonstrate the volumes of activity and associated costs expended to date with the re-opener providing adequate funding to complete the programmes.

Question 2: Do you consider our proposed approach for TMA costs to be appropriate?

The general reopener approach to the TMA element of street works costs is an appropriate approach to take. There are several known revisions to current TMA (and NRSWA) code of practices due in the next few years and there is a real possibility of continuing changes in this field for the DPCR5 period.

We suggest that information requested for any such reopener be

similar in detail to the FBPO. As much notice as possible should be given if additional levels of detail are required so that DNOs can ensure systems and controls are in place to capture the information.

We are however concerned with the approach taken to split costs between those within the price control and those excluded from the price control. This has been based upon information submitted within the LR1 and LR2 tables which are built up from a sample basis of costs (this is the only way we can estimate the split). This overlays one assumption on top of another and could not be described as a robust statistical approach.

Question 3: Do you consider our proposals for assessment of the load related reopener to be appropriate?

The elements of the assessment appear reasonable, but the magnitude of the threshold creates significant risk for DNOs, where up to 20% of base allowances, incurred through efficient expenditure and driven by external influences would need to be funded by shareholders.

In order to ensure that DNOs would be able to fund the additional expenditure up to the trigger we consider that a threshold based on 1% of revenue would be more appropriate than one based on the programme value and would align, in principle, with the trigger for ESQCR work. In addition, a 'true up' in DPCR6 would be appropriate.