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Dear Rachel,

September Update to Initial Proposals

We have already provided Ofgem with our initial reaction to the September update on the areas of flooding and the Traffic Management Act (TMA). The following response expands on this initial reaction and, in Appendix I, addresses the specific questions asked. In addition, we have taken the opportunity to set out our position following Ofgem's more recent October update.

We are encouraged by the progress made in Ofgem's October update. We believe the extensive work on opex benchmarking has produced results at an overall efficiency level that are not dissimilar with what one would expect in terms of relative rankings. Similarly, we believe the capex allowances are now more realistic. There are however a few key issues, which we believe need to be addressed prior to Final Proposals.

§ Despite being one of the most efficient DNOs overall, SHEPD has had its opex allowance cut by £12 m relative to its forecast and against a relatively small cost base. Intuitively, this does not seem right given that we operate SHEPD and SEPD in an identical manner. We continue to believe that a single regression is the most appropriate. However, if Ofgem continues with separate regressions, we believe it should re-consider its position to set allowances for indirects on the upper quartile. We believe moving to the upper third, as Ofgem has done for network operating costs, will give a small uplift across all the DNOs on a fair and equitable basis. This would help to alleviate both our concern regarding SHEPD's allowance, and the concerns of those DNOs that are fundamentally opposed to Ofgem's analysis. Moreover, it avoids the need for Ofgem to make potentially contentious DNO-specific adjustments and presents a more consistent and defensible approach to Ofgem's regression work.

§ We disagree with Ofgem's proposed approach to diversions. Ofgem has assumed that where costs in this area have been historically high, this is demonstrative of the need for higher cost allowances going forward. Conversely, where costs have been low, as is the case for SEPD, future costs will also be low. Of course, in reality, if a DNO has spent a lot on diversions in previous years and therefore done the work, the likelihood of needing to make that same spend in future years is diminished.

We submitted a forecast of £19 m for diversions in SEPD's area having spent just £5 m in DPCR4. Across the two price control periods this implies a total spend on diversions of £24 m for SEPD. Despite this, our forecast has been cut by 35%. In contrast, CN East has spent / is planning to spend £97 m across the two periods and has had its forecast cut by only 13%. This does not seem right. We believe Ofgem must revisit this and allocate SEPD an allowance in line with its forecast.

§ Due to circumstances outside our control, we have so far been unable to provide the necessary flood depth information to properly inform either SHEPD's or SEPD's expenditure in DPCR5 to limit the impact of flooding on our network. As Ofgem is aware, we are endeavouring to source the relevant information for SEPD and to provide this to Ofgem by the end of October / start of November. The situation for SHEPD is less advanced and, if this prevents Ofgem from deriving a firm *ex ante* allowance for SHEPD, we believe Ofgem must provide an alternative mechanism for us to recover these costs once known, for example an *ex ante* allowance with a true-up at the end of DPCR5. Flooding mitigation measures will most certainly be required during DPCR5. We cannot be exposed to this expenditure; equally, we cannot expose our customers to the risk of flooding on our networks.

We believe each of these issues can be resolved in the timescales remaining and are key to ensuring an acceptable settlement.

Please do not hesitate to call if you have any questions on any of the points raised above.

Yours sincerely,

Malcolm J. Burns
Regulation Manager.

Appendix 1 – Network Cost Assessment Appendix

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

Yes, we believe these are appropriate.

2. Do you consider the proposed re-opener for low volume, high cost connections and general reinforcement appropriate? Is it set at the right level?

Again, we believe Ofgem's proposed approach is appropriate.

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

We broadly agree with Ofgem's proposed categorisation of costs between re-openers and logging-up. We have been keen to limit the number of re-openers and believe Ofgem's approach is consistent with this.

We would however like to raise a number of concerns:-

(i) We do not agree that it is appropriate to 'refund' DNOs just 95% of their actual costs for HILP, CNI and black start. All cost allowances are subject to the DNO demonstrating efficient spend. We therefore do not believe that costs that are subject to a logging up mechanism should be treated any differently. DNOs must be able to recover 100% of any efficient spend. Separately, we do not believe it is necessary to set a threshold above which these costs become subject to a re-opener. We believe logging up is sufficient in this area.

(ii) On the issue of rising mains and laterals, we understand the issues that Ofgem has identified and believe that the proposal to fund the first two years of the programme upfront, with a re-opener for the later years is pragmatic. Importantly, we do not believe that individual determinations resulting from a specific case in EdF's area will provide a better or more robust basis on which to base future ownership. There are many historical and contractual reasons for why these ownership structures are as they are.

(iii) We believe there is now greater clarity from BT in relation to the changes to its communication network and this is welcomed. We have always maintained that we will work with BT to deliver the lowest cost opex-based solution so far as this is possible, but would want assurances that we could recover any additional expenditure should things change and this low-cost approach proves untenable. Whilst the latest available information gives us more confidence that our low cost opex solution will be acceptable, Ofgem's proposed *ex ante* approach does mean that we are exposed to a level of risk, which other DNOs are not (or at least to a lesser extent).

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

We raised the treatment of flooding expenditure as a particular area of concern in our initial response to Ofgem's September update. We have had difficulty obtaining basic

terrain mapping data for SEPD's area from the EA to model flood depth. This data is now being gathered and we will have this data with you by the end of October / start of November. We understand that these timescales are acceptable and will allow Ofgem to include SEPD in its *ex ante* assessment. However, for SHEPD, SEPA has yet to commence this work. This is through no fault of our own; SEPA has had the relevant details for eighteen months, but has not had the resource to carry out this work. We will therefore not have this information in the timescales set by Ofgem.

In the absence of this data, we recognise that it will be difficult to set SHEPD an *ex ante* allowance, albeit not impossible. We believe Ofgem could use our initial forecast or an average across the DNOs to allocate SHEPD an *ex ante* allowance, which could then be subject to a truing up mechanism at the end of the period. We cannot be exposed to this expenditure; equally, we cannot expose our customers to the risk of flooding on our networks. At the very least, SHEPD must be allowed to log up these costs during DPCR5.

Appendix 2 – Network Investment Policy Appendix

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

By their very nature, costs that are earmarked for re-openers are: (i) uncertain, i.e. unable to be forecasted with sufficient accuracy; and (ii) significant, to the extent that a logging-up approach during the price control is inappropriate. We therefore do not believe that the DNOs will be in a better position at the end of the second year of the price control to identify all costs in these areas. Indeed, there may still be some costs that are unknown and only realised in the later years of the price control. By fixing a one-month window early in the period, we believe Ofgem will be relying upon a considerable degree of estimation and will increase the risk to the DNOs that costs, which are at this stage unknown, are unable to be recovered despite the mechanism being in place to do this.

We therefore do not believe that such a window is workable or necessary. In our view, a licence condition similar to the current special licence condition A3 is all that is required.

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

Ofgem's proposed treatment of TMA costs is clearly wrong and we flagged this to Ofgem in our initial response to the September update. A quick review of Table 13 shows that SEPD, one of the biggest and most urbanised DNOs, is being allowed costs at the very low end of the range. This cannot be right and perversely penalises us for taking a more realistic view of TMA costs relative to other DNOs.

It is clear that there is still some ambiguity over what is covered under the arrangements. To this end, we believe Ofgem should meet with the DNOs to agree a common format for the submission of costs. Given the way in which these costs are being rolled out, we also believe that Ofgem should take the opportunity to learn from those DNOs that experience these costs first, i.e. operators in south east England. Even here, where there is greatest certainty over the scheme, the forecast costs show considerable variability. We believe

Ofgem could then use these initial costs to inform and establish a benchmark and apply a re-opener mechanism for the remaining DNOs. This is similar to the approach taken in the gas review.

3. Do you consider our proposals for assessment of the load related re-opener to be appropriate?

We are supportive of the ‘dead band’ approach for high-cost low volume work with a re-opener where costs exceed a defined trigger. However, consistent with our response to Q1, we do not believe that it is appropriate to limit the application period for re-opener to a single month, and certainly not at the end of the second year. The uncertainty of these costs, both in terms of timing and magnitude, is what lends them to a re-opener mechanism. To close this down in the second year of the price control would seem counterintuitive.

Transmission Exit Charges

Although not specifically consulted upon, we would like to reiterate a specific point in relation to the proposed transmission exit charge incentive.

Our position on the incentive remains unchanged: we do not believe it is appropriate. 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).