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Mr Richard Ramsey
Managing Director, Regulation and Financial Affairs
Office of Gas and Electricity Markets
9, Millbank
London
SW1P 3GE

Our ref B12/424

Your ref

Date 08 April 2003

Dear Richard

Developing Network Monopoly Price Controls - Update Document

I refer to the above document published on 12th February. Our detailed comments are attached.

The separation of Supply and Distribution activities allows the development of robust bench-marking of the costs of operating differing mixes of assets and the robust comparison of the non-networks overheads that are essential to run a successful distribution business. Assets drive the variable element of operating costs and this has been demonstrated in our acquisition of the South Wales distribution network where accurate operating costs were predicted using an asset based model.

Meaningful operating cost comparisons between companies can only be achieved by clear definitions of cost for each activity. The current situation is not transparent with cost allocations, differing accounting treatments of capitalisation etc providing little confidence in comparing like with like. We would welcome any opportunity to assist in achieving greater clarity as we believe that a business that does not have any interests in generation or supply can give a unique insight into costs and their drivers.

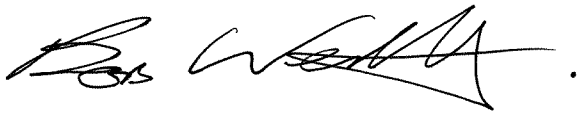
We fully support proposals to introduce rolling adjustments to both operating costs and capital expenditure as we believe that these enhance the incentives to realise costs savings whenever opportunities arise and also assist with obtaining the ongoing funding of companies.

Efficiency, however, is not just about costs. The October 2002 storm demonstrated that a 'frontier' company identified at the last review in terms of operating cost could not deliver basic services. We welcome the recognition that outputs as well as cost need to be taken into account when company comparisons are made.

Our comments above underline an approach that is one of understanding, transparency and clarity. We believe that this fourth review of DNOs should not be searching via theoretical modelling for what drives cost in distribution businesses – the evidence is apparent. The rigour applied to IIP is necessary to conduct a fair and equitable review and we will do our utmost to assist Ofgem during the process.

Please do not hesitate to contact me should our response require further clarification or discussion.

Yours sincerely



R G WESTLAKE
Regulatory & Government Affairs Manager

W273902

Developing network monopoly price controls

Update document

February 2003

ISSUES FOR CONSIDERATION

3.12 Ofgem would welcome views on any of the issues raised in this Chapter and in particular on:

whether there are any aspects of the electricity transmission framework that should be applied in electricity distribution and the most appropriate timing for doing so, including the regulatory, technical and commercial issues that would arise.

Aspects of the Transmission Framework may become appropriate as Distribution Networks become more active. This may happen with the introduction of distributed generation but in our view is unlikely over the next review period. When these markets have further developed it may be a more appropriate time to consider whether there should be increased alignment between transmission and distribution.

4.20 Ofgem would welcome views on any of the issues raised in this Chapter and in particular on:

the most appropriate balance between protecting consumers and providing companies with incentives towards efficiency and in particular the length of time that companies should be allowed to retain efficiency savings;

The structure of the UK electricity industry is such that cost reductions made by DNOs may not be passed on to customers. Therefore, the best way to incentivise the DNO to protect the customer is by setting customer service and reliability targets.

Ofgem's intention to allow companies to retain efficiency savings for a fixed period of time including for the DNOs the detailed issues set out in Appendix 3;

The retention of Capex savings for a fixed period of time creates an environment where savings are realised as soon as possible and hence provides earlier benefit to the customer. We support the rolling average principle as it provides balanced incentives to find efficiency savings and would provide certainty for funding companies.

the most appropriate way of reducing the distorted incentives between opex and capex and in particular:

- *the form of a value for money model that could be used to assess efficiency and provide incentives to companies;*

- *whether it would be appropriate to provide more balanced incentives between opex and capex and the impact that this could have on retention periods and the incentives that companies have to provide a good quality and security of supply; and*

The customer should receive value for money which is not just about cost but also about the product being delivered. The frontier performance approach used in the last review should, therefore, be normalised for outputs - lowest cost does not equal most effective. The October 2002 Storm is a good example where a company assessed as a frontier performer in the last price control did not provide basic services to the customer.

A way of reducing the distorted incentives between opex and capex is to have very clear definitions in these areas including consistent accounting policies and allocations. This also assists transparency in other areas. If there is a clear understanding of Opex and Capex there should be no need to to assess efficiency based on total costs. It is preferable to provide very clear, activity based, definitions of what is considered to be Opex and Capex rather than accept that there is an unclear boundary.

the treatment of non-operational capex.

Non operational capex should be included in the RAV and depreciated over a period of time. Investment is primarily IT and tools so a 5 year period would seem appropriate as this represents the typical asset life of these products.

5.15 Ofgem would welcome views on any of the issues raised in this Chapter and in particular on:

the way in which the incentive and price control framework should be developed;

Comparative Regulation

Comparative regulation has produced significant cost reductions since privatisation. However, the basis on which comparisons can be made has been enhanced significantly since the last Review because of the separation of distribution business from supply and other businesses. For a standalone DNO cost drivers and business needs are now transparent because a causal cost analysis is now available. It is therefore neither sound nor necessary to use regression as a primary comparative tool. (In the past, in the absence of known operating cost drivers for Distribution Businesses, linear regression has been attempted in order to determine an approximate/proxy 'efficient frontier'.)

Comparison of costs between DNO's is not always straightforward given:-

- Different accounting policies, especially on capitalisation
- The presence of allocated costs in integrated businesses
- Some elements of cost being fixed, and others variable
- There are a number of drivers for cost variation, depending on the cost involved (but

very little cost varies as a result of customer numbers)

Direct network costs

WPD has developed a model that calculates direct network costs based on the actual assets operated and has made this model available to Ofgem. The model calculates the expected direct network operating cost given the actual network assets, in a way analogous to that in which IIP calculates the expected minutes lost and interruptions. The model is constructed to take account of:

- Volumes of asset groups (by voltage level, asset type etc)
- Fault rates by asset
- Relatively fixed costs (eg wayleaves, mapping centre)
- Variable costs based on actual experience of maintaining real assets.

Indirect costs

- A DNO's indirect controllable costs and corporate overheads comprise the costs of IT, telecoms and other activities such as finance. These costs represent a significant portion of total costs and are largely fixed. Comparing the costs of performing these functions is hampered by different allocation within businesses of the costs and different capitalisation policies. Therefore, in order to make the comparison it is necessary to either specify in detail (and audit) a common allocation process or to compare the cost of these activities on a total cost basis. Determining a common allocation basis would be complex and it therefore more straightforward to compare these costs on a total cost basis. (The imposition of detailed accounting rules as used, for example, by the US FERC would result in significant costs being incurred by DNO's without any reasonable expectation of benefit for customers)

Comparing costs

The transparency of cost causation that is available as a result of business separation should enable a cost comparison methodology to be developed that:

a) compares direct network operating costs by benchmarking the cost of maintaining each asset type (including tree trimming) and then applying the benchmark to the actual number of assets in the network.

b) compares the indirect costs on a total cost basis – i.e. ignoring the effect of individual companies' capitalisation decisions. I.e. comparing the total cost of performing each activity/function within a company and the total cost of all indirectly costed activities.

c) How much capital expenditure is required will depend on the age of the network and the amount of replacement required over the next quinquennium. This amount of capex allowed should therefore be determined on the basis of an independent engineer's assessment of the replacement required.

d) In all of the above analysis allocated costs should be treated as if they were cash spent on the basis that they were allocated on an arm's length basis.

The extent to which DNOs have complicated their accounting arrangements, by for example setting up "internal" outsourcing arrangements, or complex cost allocations is not a barrier

todetermining benchmarks for direct network or other costs by activity/function. Conversely, unless all DNO's utilise the same basis of allocation, using allocated or fully absorbed costs would undermine the validity of the comparison.

Pension Costs

A significant area of cost uncertainty relates to pension cash contributions. Pension cash contributions required are dependant on:

- Trustees investment decisions
- Stock market / Bond market movements
- Legal requirements imposed on the companies at privatisation

The cash requirements are therefore not subject to management decision or control. We would propose that some form of pass through mechanism be adopted for non-exceptional contributions (ie excluding early retirement deficiency costs, which Ofgem has already issued a determination on). If and when the markets pick up, any pension contribution holidays would also be subject to the pass through mechanism.

Ofgem's initial thoughts on the incentive framework that should be put in place for the DNOs;

We agree that the methodology needs to differentiate between those areas where distributors have control over their costs and those where they do not.
The methodology should cover:

a. Benchmarking Operating Performance
b. Benchmarking Network Operating Costs
c. Treating as passthrough areas out of the DNOs control

the approach to assessing consumers' willingness to pay and in particular the areas that should be covered in any consumer research (Appendix 4);

Whilst understanding consumers preferences, both in terms of the outputs which they value and what they are willing to pay for, is desirable it is also necessary to be mindful of the practicalities associated with delivery of expectations. Networks have evolved in such a way that it is difficult to extract particular customer groups and address solely that groups expectations.

quality and security of supply issues for the DNOs and in particular (Appendix 5):

- *the treatment of the OSs and whether they should be included in the IIP incentive scheme;*

We believe that both OSs and companies performance in term of customer complaints to Energy Watch should form part of the IIP incentive scheme and would welcome further discussion on this subject. It is essential that the target setting exercise recognises the relative performance of the companies.

- *the scope and form of the exemptions under the GOSPs and the exceptional circumstances mechanism under the IIP; and*

In our view the severe weather exemption should remain. Whilst the incentive to restore customers could be seen to be weakened when an exemption applies, there is also a major downside to removing the exemption. A key element in dealing with an emergency quickly is the ability to call on expertise from other DNOs not affected by the emergency. This inevitably means work which would previously have come under the GOSPs would incur financial penalties with the result that companies not affected would be reluctant to release resources in a timely way. The DTI report on the October 2002 storms recognised that uninhibited sharing of resources was a key factor in speedy restoration.

With regard to the additional burden on Ofgem in dealing with determinations following the storm it should be noted that WPD experienced the highest winds for the longest period of time, had the fastest restoration and had no storm related Ofgem complaints. This reinforces our view that the existing severe weather exemption is appropriate.

We support the work that Ofgem is pursuing to determine objective measures based on the number of faults experienced in a 24 hour period to define exemptions. We also support that such exemptions should only be granted following evidence being provided to demonstrate that appropriate mitigating action has been pursued. The presentation given by Chris Watts/James Hope to the DRMM suggesting a process for assessing weather related exceptional events appears to address these issues satisfactorily.

- *the most appropriate way of setting targets for the number and duration of interruptions to supply including whether targets should be set for a period for longer than the price control period and if so how this could be introduced.*

We attach our detailed ideas on how these targets can be set.

6.29 Ofgem would welcome views on any of the issues raised in this Chapter and in particular on:

the implications of the financing obligations and duties on Ofgem and licence holders;

We fully support Ofgem's intention to target credit ratings which lie 'comfortably' within the investment grade category.

The process of determining a DNO's credit ratings is not based entirely on each DNO's financial status. In particular, Standard & Poor's rating methodology bases a DNO's rating on the rating of its parent group and it is therefore possible for a financially sound DNO to be rated below a "comfortable investment grade" for no other reason than its ownership. One reason for this may be the possibility that the rating agencies do not regard the regulatory ring-fence provided by licence conditions as sufficiently strong enough to protect regulated entities (and, in particular, not as strong as that provided for in the licences of regulated water undertakings). Although we do not agree that this is the case, Ofgem's targeting a rating, is evidence of Ofgem working with the agencies. We would encourage Ofgem to work with the agencies, and in particular S&P, to ensure that each DNO's rating be determined on the basis of it's particular circumstances, even if this involved some further development of the regulatory ring-fence.

the approach to estimating the cost of capital and in particular issues associated with:

In the last review Ofgem took a forward-looking view to determine the appropriate cost of capital allowance. We believe that Ofgem should continue with this approach, as stability will allow DNOs better access to capital markets and maintain the current low cost of capital.

The Oxera report on the cost of capital for DNOs (March 2003) concludes that "the forward-looking real, pre-tax WACC of DNOs is therefore likely to be *at least* 7%." The report finds that the inputs into the WACC have not changed since the last review other than:

1. the equity risk premium ; current market evidence suggests that the forward-looking ERP has increased from 3.5% at the last review to currently a mid-point of 4.0%
2. the debt premium ; current market evidence suggests that for BBB-rated debt the premium above gilts is at least 200 basis points (last review 180 basis points)

WPD has commissioned a study by NERA (www.nera.com; "Recent Evidence on Beta and the Cost of Capital for UK Electricity Companies": 29 January 2003), which concludes that an equity beta of 1.0 is still appropriate.

- *the approach to gearing; and*

We consider that Ofgem should maintain consistency with the last review where a 50% gearing assumption was made. The Oxera paper for OFWAT in 2002 supports this assumption, concluding 50% to be appropriate.

- *taxation;*

The Inland Revenues intention to discontinue 100% capital allowances on non-load related capex from April 2005 significantly increases tax cash outflows. We consider that a post-tax rate of return is now appropriate as it takes account of tax cash outflows.

- *fixed costs of debt; and*

WPD commissioned a study by NERA which concluded that an equity beta of 1.0 is appropriate for this business - fundamentals of DNOs have not changed.

the RAV and the approach to depreciation and in particular on:

- *the way in which the RAV should be updated for capex efficiencies;*

We support a rolling adjustment

- *the approach to asset disposals;*

We support assets remaining in the RAV for a period of 5 years following their disposal.

- *the treatment of non-operational capex in the RAV; and*

We believe that non operational capex should be included in the RAV and depreciated over a period of 5 years.

- *the most appropriate way of dealing with the sharp fall in Vesting asset depreciation for the DNOs.*

WPD agrees with Ofgems initial view that the adjustment that was made to the depreciation profile of some companies at the last review should be extended to other DNOs.

We support Ofgems view that a significant increase in investment in distribution networks will be necessary to support the growth in distributed generation and asset replacement. In order that there is a smooth passage to increased capex requirements it is appropriate to finance a proportion of investment through the profit and loss account (Transco precedent).

7.39 In addition to the issues identified above it is also necessary to consider:

how far beyond the end of the next price control which ends in 2010 should DNOs be required to forecast their costs – although the price control allows companies to recover sufficient revenue to meet their statutory and licensed requirements it is important to have an understanding of the impact of the price control beyond 2010 on both the financial position of the companies and the likely path of prices to consumers;

We believe that it is appropriate to produce forecast of capital investment to 2020 and to identify those areas of operating costs where significant uncertainty exists in their path beyond 2010. The majority of existing operating costs are likely to continue at or near current levels if existing levels of output performance are to be maintained.

the best of way of ensuring that there is an appropriate level of transparency and openness in the information that companies submit to Ofgem - one approach would be to require DNOs to publish their business plans. Ofgem recognises that some of the information that companies submit may be need to be treated in confidence but the burden of proof in such matters should rest with the company. It will also be important to ensure that any information that is published is done so in a consistent and logical way so that interested parties can more readily make comparisons across DNOs; and

whether it is appropriate to require that the Board of the licence holder and its parent company Board endorse the strategy and information set out in a company's submission. It is also necessary to consider whether any aspects of a company's submission should be subject to some form of audit, and if so, what form this should take.

In the interest of maintaining transparency and openness, we would have no objection to publishing our Business Plan.

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS UPDATE DOCUMENT FEBRUARY 2003

Section 5: Developing the Overall Incentive and Price Control Framework; and Appendix 5: Developing Incentives for Quality of Service for the DNO Price Controls

One of the issues for consideration raised in section 5 is:

> "the most appropriate way of setting targets for the number and duration of interruptions to supply including whether targets should be set for a period longer than the price control period and if so how this could be introduced"

In Appendix 5, it is stated that:

> "Ofgem will need to consider the most appropriate way of setting targets for the DNOs that:
>
> - Provide an appropriate level of protection to consumers and are consistent with a level of service that they are willing to pay for;
> - Reward those companies that are the best performers during the price control period;
> - Are consistent across companies;
> - Are realistic and achievable and consistent with the cost assumptions underlying the price controls".
>
> and
>
> - "A number of issues will need to be considered when deciding on the most appropriate length of time that targets should be set for:
> - The relationship between expenditure and performance will need to be better understood – Ofgem does not want to set targets for companies that are inconsistent with the cost assumptions underlying the price control;
> - Whether it would be appropriate to set targets for outputs beyond the period for which detailed assessment of costs are made and the incentives that this would provide to companies;
> - Whether it was possible to build an appropriate level of flexibility to the arrangements".

On the following pages a suitable framework is outlined.

FRAMEWORK FOR SETTING QUALITY OF SUPPLY TARGETS AND EVALUATING ASSOCIATED COST

The setting of quality of supply targets must take account of the interdependency between:

- Long term quality of supply objectives;
- The costs associated with achieving the required improvement, i.e. performance gap closure;
- Customers' willingness to pay for the improvement in service; and
- Short term quality of supply targets.

Principles

In order to develop quality of supply targets that are consistent and equitable across DNOs, it is essential that quality of supply targets are set with reference to comparative performance. The Comparing Quality of Supply Working Group has identified an effective method of comparing quality of supply, the work of this group should be used to underpin consistent target setting.

Short term quality of supply targets, say for a 5 year price control period, should be set in the context of longer term, say 15 or 20 year, quality of supply objectives. This will promote the implementation of a balanced set of improvement initiatives that are consistent with both the short term targets and long term objectives.

Long Term Quality of Supply Objectives

In order to set short term quality of supply targets in context, it is necessary for Ofgem and DNOs to form a collective view of the long term quality of supply objectives. An appropriate long term objective would be for all DNOs to provide the same level of quality of supply output, when compared on an equitable basis. In quantifiable terms, the long term objective would be for all DNOs to deliver a level of performance that is broadly consistent with the current upper quartile performance.

Evaluation of historic quality of supply performance, warts and all, suggests that no DNO sets the performance frontier year on year. However, the superior performing DNOs are consistently upper quartile performers, as shown in attached chart. On balance, it would not be appropriate to set a long term objective for all DNOs to deliver a level of performance that is consistent with the current frontier.

For each DNO it will then be possible to identify the gap between their current level of performance and the long term objective.

Costs of Achieving the Required Improvement

The Ofgem working group focussing on Comparing Quality of Supply Performance has identified an "end to end" process that:

- Provides an effective method for comparing DNOs' quality of supply performance on a more equitable basis;
- Enables the high level drivers that underpin performance gaps to be identified;
- Enables effective performance gap closure strategies to be developed; and
- Allows the costs associated with the performance gap closure strategies to be evaluated on a total cost and marginal cost benefit bases.

Through the application of the "end to end" process, the performance gap closure strategies can be ranked in terms of their cost effectiveness. The process will allow the relationship between expenditure and performance improvement to be explored and a greater understanding of the relationship developed.

Short Term Quality of Supply Targets

In order to derive short term quality of supply targets, i.e. for a 5 year price control period, it is necessary to distinguish between DNOs who perform better or worse than current upper quartile performance.

For DNOs whose quality of supply performance is worse than upper quartile, a glide path can be established from their current level of performance to the long term objective. The slope and duration of the glide path can be modified in the short term to ensure that it is consistent with customers' willingness to pay and the cost of delivering the required improvement. This is illustrated on the attached chart. These DNOs will be incentivised to deliver the targets in order to avoid penalties, or to outperform the targets in order to receive rewards.

The short term targets for DNOs whose quality of supply performance is equal to or better than upper quartile should be the current quartile level of performance. These DNOs will be incentivised to continue to deliver upper quartile performance in order to receive appropriate rewards. This would be consistent with rewarding those DNOs that are the best performers during the current price control period by setting them less demanding targets.

Costs appropriate for delivering the short term quality of supply targets can then be factored in the price controls.

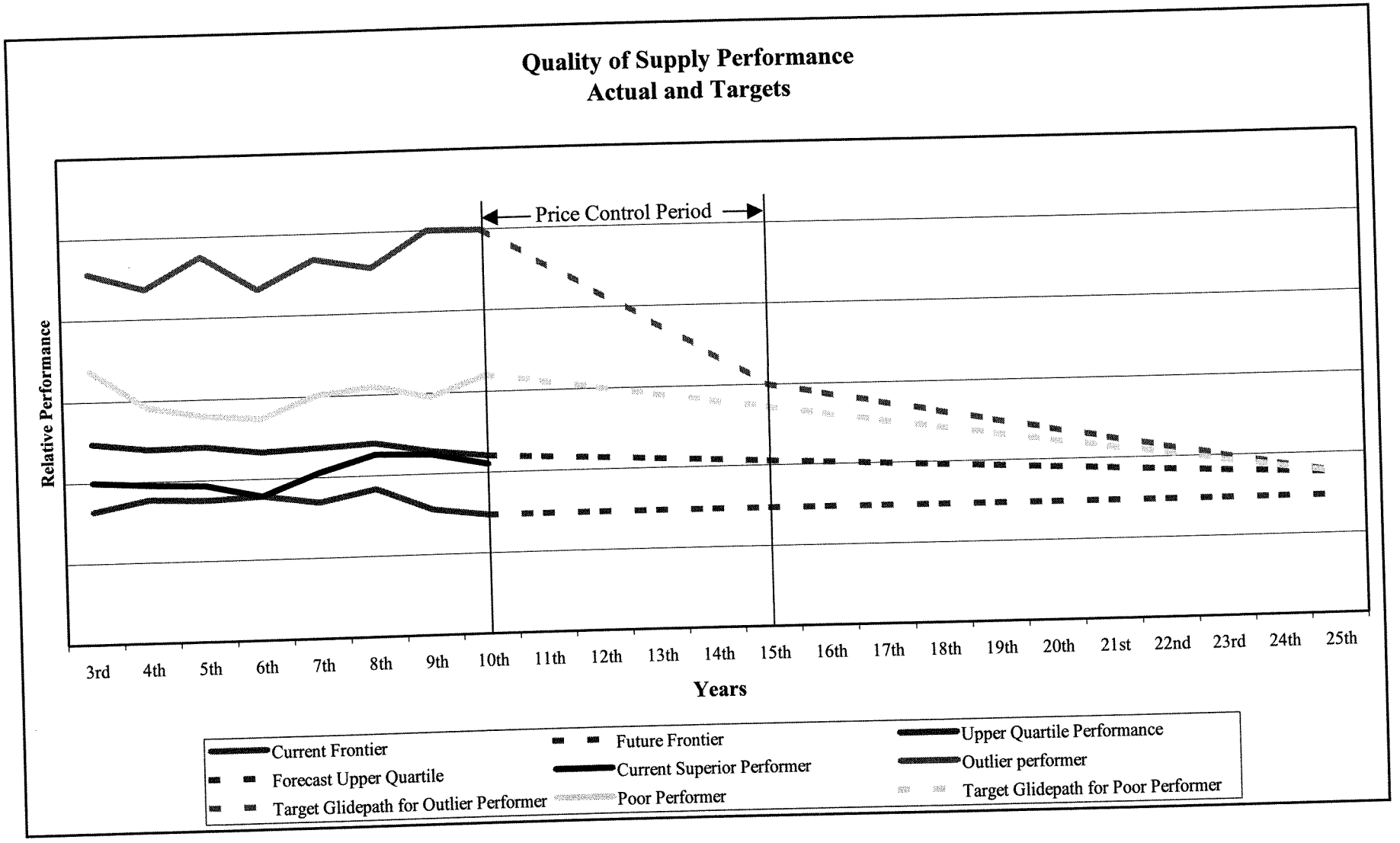
Other Issues

The process of setting short term targets in the context of long term objectives can be repeated at each price control review.

Performance in any one year can be influenced by either:

- An exceptional event (e.g. severe weather on one or two days); or
- Random annual variability, (e.g. a number of major events, where each event on its own would not be significant).

Exceptional events should be excluded from both the target setting process and the valuation of whether a DNO has delivered against their targets. In order to negate the effect of a random annual variability, annual performance data should be smoothed by using a rolling average of, say, three years. The smoothing of output data would also allow for the inherent lag between the implementation of an initiative and the results being evident.


Quality of Supply Performance
Actual and Targets
Price Control Period
Relative Performance
3rd
4th
5th
6th
7th
8th
9th
10th
11th
12th
13th
14th
15th
16th
17th
18th
19th
20th
21st
22nd
23rd
24th
25th
Years
Current Frontier
Future Frontier
Upper Quartile Performance
Forecast Upper Quartile
Current Superior Performer
Outlier performer
Target Glidepath for Outlier Performer
Poor Performer
Target Glidepath for Poor Performer