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Our ref	Your ref	Date
	jm37-03lpl	9 October 2003

Dear Chris

Ofgem's three year strategy 2004-7

Thank you for your letter of 1 September in which you asked for views to assist in determining Ofgem's future strategy from 2004 to 2007. I am writing on behalf of Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc.

It is helpful that Ofgem have in place a three year strategy. This greater transparency assists WPD in our planning of the regulatory workload and priorities.

1. The key challenges you consider the industry faces in the short to medium term

A key challenge will be to undertake and complete the Distribution Price Control Review (DPCR). WPD is a pure Distribution Business with no Supply Business. This has brought clarity to the cost drivers associated with a DNO and we strongly believe these to be network asset driven. WPD operates a large network in a hostile weather environment heavily populated with fast growing trees (the main causes of faults on the overhead network) requiring significant expenditure on vegetation management. Despite this, WPD is a frontier performer in terms of Customer Service, System reliability and Storm performance and believe this should be recognised in the Review.

The Energy Policy is a key external factor that will have a major impact on the electricity industry with long term implications, presenting challenges for us all. The increase in renewable/embedded generation has significant implications for DNOs and we believe Ofgem need to ensure that appropriate incentives are placed on distributors to connect distributed generation and to enable full cost recovery. We are actively involved in the Distributed Generation workstreams and have previously proposed a charging methodology to assist embedded generators.

The Streetworks trials taking place in selected parts of the UK present a major challenge to companies currently and potentially to all DNOs in the long term. The issues surrounding this and the cost implications should therefore be of importance to Ofgem.

2. *What action do you consider the Authority should take to respond to these challenges*

When planning for 2004-7 Ofgem will no doubt take account of the revised Social and Environmental Guidance following the publication of the energy policy white paper.

The Authority needs to ensure that any National Streetwork proposals are considered carefully and full cost recovery is allowed so as not to either disincentivise companies to undertake essential works or to cause companies to defer expenditure elsewhere in order to cover the costs associated with the Streetwork proposals.

3. *Are there new areas if work that, you believe, should be set in train and what degree of priority should they be given?*

We welcome the recent decision to undertake Regulatory Impact Assessments and ask that this may continue for all major areas of work being undertaken by the Authority.

4. *Is there existing work that could be given greater or lesser priority or even stopped?*

The Distribution Price Control Review needs to be given a very high priority in 2004 – 2005 and appropriate resources allocated. It is essential that the outcome of this review ensures long term investment and sustainability in electricity distribution and recognises performance. Critical to this process will be the consideration of balancing future investment levels to either maintain or further improve the quality of supply against the impact on prices. Future assets replacement needs are driven largely by original installation profiles. Whilst currently forseeing an increased replacement need we do believe there is a significant cliff-face of expenditure.

In determining efficient costs and rewarding out-performance two elements need to be considered. Firstly for benchmark costs what are the efficient costs and secondly the reward mechanism for out performance. IIP has established the benchmark performance for a given set of network characteristics and so the costs to operate at benchmark network performance need to be established. The expected cost for each company should be set by reference to the causes of costs (or "cost drivers"). The causes of costs for each of these activities can be summarised as being between those costs that vary with the number and type of assets a DNO operates, those costs that vary with customer numbers and those that are fixed. Our analysis shows that 79% of costs are asset driven and 19% are fixed. The balance of 2% are customer driven. In effect a normalised cost needs to be established for each company assuming that it delivers benchmark performance. Modifications for weather, tree growth, etc need to be taken into account. Companies who exceed benchmark performance out-performance should be financially rewarded.

Priority within the DPCR should be given to the treatment of pension costs. Pensions costs are either a staff related cost or otherwise arise as a result of events outside of a

DNOs control. To the extent that staff costs include pension costs for those staff, they are already dealt with within the assessment of efficient opex. To the extent that additional costs arise as a result of events beyond a DNOs control since both DPCR3 and the last actuarial valuation (stock market movements) they should be allowed as a pass-through as they are not controllable but is separable.

Following implementation of the DPCR in April 2005 we would support a review to evaluate the process, methodology and the outcome in order to assist in considering the best way forward for DPCR5. We would welcome a publication of a consultation in this respect.

We look forward to the publication of the Three Year Strategy next year. I trust that our comments are helpful, please feel free to contact me if you require any further information.

Yours sincerely

R G WESTLAKE
Regulatory & Government Affairs Manager