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Our ref	Your ref	Date
518 / F9		19 November 2003

Dear Nienke

Electricity Distribution Price Control Review - Update Document

I am writing further to the above document on behalf of Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc.

Chapter 3 – Form, structure and scope of price controls

- **the application of the rolling adjustments for opex and capex; and**
- **the losses incentive**

WPD supports rolling adjustments for both opex and capex. In respect of Capex we support the rolling RAV adjustment methodology put forward by the DNOs. The discussions and work with Ofgem on the rolling RAV was very useful and we feel there would be merit in a similar approach for opex.

Chapter 4 – Quality of Service and Other Outputs

- **Results from the first phase of the consumer survey**

Results of the first phase of the consumer survey have been noted.

WPD will provide responses to the specific questions that have been raised in the forecast business plan questionnaire.

- **Measurement and incentives in respect of network resilience**

The British Power International (BPI) report on the October 2002 storms indicated that if identified DNOs implemented their specific initiatives, then all DNOs would be capable of delivering storm resilience performance consistent with existing benchmark DNOs. No improvement initiatives were identified for the benchmark DNOs. Whilst these DNO specific initiatives could be implemented within the boundary of existing levels of charges, there was no indication that benchmark performance could be improved.

Measurement of network resilience

We agree with Ofgem's view of the key elements associated with network resilience.

The first element, the ability of a network to withstand an exceptional event, is difficult to define on an equitable basis across DNOs. The effect of a 70mph South Westerley gale will be different in different parts of the country and therefore 'defined' weather conditions will impact companies in different ways.

The second element, the ability of a company to respond to an exceptional event, is clearly within the control of the company.

An incentive mechanism should be introduced whereby DNOs are rewarded (penalised) for good (poor) performance during exceptional events.

Set against an understanding of the scale of the exceptional event, performance can be judged across a number of criteria such as:

- Mobilisation of resources;
- Customer call handling;
- Communication with customers, Ofgem and energywatch,
- Management of fault repairs, and
- Effectiveness of IT systems.

DNOs performance could be scored against the selected criteria. Good performers would be rewarded and poor performers penalised.

This could be carried out on an annual basis and would not be overly cumbersome to implement as much of this assessment would already be carried out in determining whether the event was exceptional for the purposes of exclusion under IIP.

- **The approach to disaggregating and comparing quality of supply performance**

WPD is supportive of the approach and process used by Ofgem for disaggregating network performance because they provide a robust basis for both inter-DNO performance comparison and for setting consistent targets for all DNOs. However, consistency of targets across DNOs does not necessarily mean that the targets are equally challenging. Whether the targets are equally challenging targets will depend on operating cost and capital expenditure assumptions.

- **Rewarding frontier performance**

Assessing Frontier Performance

We agree with Ofgem's proposal that frontier performance should be determined by assessing both CI per 100 customers and CML per customer relative to their benchmark performance.

We propose that the best four performing DNOs in respect of CI per 100 customers and the best four performing DNOs in respect of CML per customer performance should be regarded as frontier performers. This will provide a DNO with the opportunity to be identified as a frontier performer in terms of both CI per 100 customers and CML per customer.

Rewards

Ofgem have proposed that the reward regime for frontier performing DNOs should be in two parts.

The first part of the reward regime is that frontier performers will have access to the IIP out-performance reward mechanism (i.e. rate of improvement relative to 2001/02 actuals), irrespective of whether the frontier performers have meet their 2004/05 targets. However, because of the inequality of the existing 2004/05 targets it is likely that DNOs that deliver the same frontier performance would receive materially different rewards.

The second part of the reward regime for frontier performers is that they should be automatically set lower future rates of improvement. To sustain frontier performance is very challenging for a DNO. Consequently, this part of the reward regime does not provide appropriate reward for achieving frontier performance historically.

WPD proposes that frontier performing DNOs should receive the full out-performance reward.

- **Scope of the output incentive scheme for the next price control period**

We agree that the results of the consumer survey suggest that the existing scope of the quality of service incentive scheme is broadly appropriate because they relate to the whole customer base. It would be inappropriate to include in the incentive scheme output measures that relate to subsets of the customer base because this may create perverse or conflicting incentives.

- **Changes to the standards of performance arrangements**

WPD will provide responses to the specific questions on changes to the standards of performance arrangements that have been raised in the forecast business plan questionnaire.

Chapter 5 – Distributed Generation

- **the summary information on the volume and costs of distributed generation;**

We believe that there is great uncertainty over the volumes and costs of future distributed generation. Distributors have little influence over these as they will be driven by factors outside distributors control e.g. planning permissions, value of ROCs, generator technology development etc.

- **the incentive framework for distributed generation and in particular:**
    - **the proportion of costs that should be passed through;**
    - **the best of way of incentivising DNOs to provide network access to distributed generators on an ongoing basis; and**
    - **whether similar arrangements could be applied to demand customers;**

We continue with our concerns with the proposed hybrid mechanism. As highlighted previously, these are:

- it is inappropriate to earn a lower rate of return on assets installed on the basis of information accepted in good faith at the time of connection if the connectee subsequently reduces their usage
- the method will encourage deferment of network reinforcement to the latest possible time to give the maximum certainty that the generation is connected
- with a differential return, there will be disputes over the split of investment between that needed for generator connections and that for other purposes

Whilst having more risks in the period of the price control, we believe that a £/MW driver (possibly differentiated into ‘baskets’) with logging-up of assets to enter the RAB at subsequent price reviews represents a more stable long term investment environment. The issue of an ‘efficiency test’ for any stranded assets is the same issue that applied to existing reinforcement investment that is assessed as part of the price control.

We believe that the application of similar arrangements to demand customers will lead to greater regulatory intervention and uncertainty.

- **interest in IFI Category C activities and the potential benefits of providing funding for them; and**

In general we support research on the application of technology and materials rather than more fundamental research into the properties of materials which would fall under category C of the IFI.

- **from DNOs, examples of the opportunities they anticipate for RPZs. This will enable us to test our proposals against a more realistic set of examples and will assist us in refining our thinking. These proposals could be conceptual or related to an actual part of a DNO system and will be treated in confidence if requested.**

We are unlikely to proactively seek RPZ opportunities, as we believe that we could tie up important manpower resources with the potential for no return. However we will support proposals from developers wishing to develop an RPZ within our network.

5.29. Respondents are also invited to present estimates of the costs and benefits of the proposals as presented in the RIA (Appendix 1).

We have no information to add to that provided in the DG BPQ.

Chapter 6 – Assessing Costs

- **the issues involved in normalising DNOs costs;**
- **Ofgem's approach to benchmarking including the issues set out in paragraph 6.27 and those raised in CEPA's report;**
- **the effect of mergers on the cost assessment work; and**
- **the use of total factor productivity estimates.**

Our comments on this chapter are included in our separate response to the CEPA report.

Chapter 7 – Financial Issues

- **Views invited on revised guidelines**

WPD reaffirms its agreement with OFGEM's principle that recognition of pension costs should be included in the allowed income for DNO's, i.e. the running of an efficient pension scheme is an inherent part of running an electricity distribution business.

WPD also supports the principle that it is appropriate to restrict deficit funding to regulated distribution and metering business liabilities. We believe that whilst historic data is patchy, we can assess that there is sufficient factual employment cost data in the prospectus and regulatory accounts, which together with Company pensions data, will enable a reasonable estimate of the distribution and metering business liability to be made.

WPD estimates that at least 85% of past service liabilities should be allocated to distribution.

We strongly disagree with OFGEM's view that companies should be penalised for not making payments into the scheme at the time it was in surplus. We are of this view because:-

- unless OFGEM put in place specific conditions, companies are under an obligation to behave like prudent business people
- there were no pension conditions in the previous reviews
- at all valuations since privatisation there were large surpluses
- A prudent business person would not have made contributions or payments whilst it was in surplus

It follows from the above that distribution and metering business deficits that fall to be funded from regulated revenues should not be reduced as a result of companies funding ERDC's from surplus. WPD is of the view that customers have benefited, and continue to benefit, from efficiencies achieved through staffing reductions. Further:

- without the available surplus the cost of achieving the efficiencies would have rendered their implementation imprudent
- the savings have been reflected in reductions in allowable income at each subsequent price review i.e. the companies benefit for a few years, at most 5; customers benefit for an infinite amount of time thereafter

The reason for the current deficit is the change in the markets (i.e. not the actions taken prior to 2001), and it is therefore reasonable to expect the deficits to be eliminated as markets recover.

We continue to be of the view that it would be more appropriate - both in principle and pragmatically - for the distribution element of pensions costs (both past and future service) to be reflected as a pass through cost in line with Frontier Economics' recommendations to Ofgem.

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