Electricity Distribution Price Control Review
Second Consultation - December 2003

Response by Western Power Distribution – February 2004

Executive Summary

CHAPTER 3. FORM, STRUCTURE AND SCOPE OF THE PRICE CONTROLS

- The addition of a capacity component is likely to add complexity and be difficult to calibrate. The existing form of revenue driver has proved robust and has not introduced perverse incentives

- We have very limited control over NGC exit charges and hence these should continue to be a pass through item

- EHV charges should be covered by the price control

- The degree of control that a DNO has over the level of rates is at best extremely peripheral - rates therefore should be a pass through item

- For risks that are uncertain, (for example lane-rental charges or new safety related costs) there should be a formal mechanism that allows distributors to recover costs within the review period that have been reasonably incurred and have not been allowed for in price controls

- The suggestion of backdating the return on efficiently incurred overspends would be appropriate. We also agree with the proposal that rewards for capex efficiency should be linked to the size of the initial capex allowance.

- Whilst valuing meter assets on a depreciated replacement value partially addresses the issue of losing the value of historic investment, it does not remove that risk and would constitute a change in regulatory expectation. This issue would be fully addressed by including termination fees in any separate price control for MAP.

- In considering separate price caps for MAP and MOP, there will need to be some recognition that an element of the charge will be based on fixed costs. The price cap may need to be varied to reflect changes in volume if a DNO retains the obligation to provide services and cannot withdraw from the market if volumes are insufficient to cover costs. This can be overcome by recognising that fixed costs associated with licence obligations can be recovered through DUOS charges if insufficient income is available from metering charges.

CHAPTER 4. QUALITY OF SERVICE AND OTHER OUTPUTS

- The second stage of the WTP survey should establish more clearly the exact relationship between the costs to put proposed new or tightened standards in place and the willingness of customers to pay for these improvements. It is important that that any subsequent changes to the standards of service accurately reflect these findings

- We propose that it would be appropriate for the IIP incentive scheme associated with quality of supply to be developed into a symmetrical scheme with rewards and penalties applicable each year

- We propose that it would be appropriate to use performance dead-bands as a means of minimising minor performance variability

- The disadvantages associated with the use of rolling average performance outweigh the advantages

- It would be appropriate to maintain the current level of total financial exposure.

- The most appropriate means of addressing the perverse incentives associated with the deferment of planned works during 2004/05, would be to allow DNOs to "roll forward" a proportion of their planned interruption performance from 2004/05 into 2005/06

- The removal of the exclusion of exceptional events from the financially incentivised IIP output measures effectively destroys the rationale for establishing IIP and would not promote improvements in the ability of a company to respond to a severe weather event. WPD, the benchmark company in the October 2002 storm, experience extreme conditions more frequently that those companies who performed badly in October. OFGEM's own investigation and report supported this fact and so this proposal would unfairly penalise WPD

- An incentive mechanism should be introduced whereby companies are rewarded (penalised) for good (poor) performance during severe weather events

- The performance of the telephone infrastructure is not under the direct control of companies, for example, during October 2002, some companies experienced difficulties as a consequence of the failure of BT equipment. The most realistic option is the ex-post performance assessment

- WPD has historically reported, through the former Electricity Association, system losses, fluid lost from fluid filled cables, SF6 in use and SF6 lost, road excavation to landfill, and environmental prosecutions. We have also developed internal systems following previously issued DEFRA guidelines data on greenhouse gas emissions related to various WPD activities. The imposition of additional

reporting requirements needs to be considered very carefully to check that there is a real and justified need

CHAPTER 5. DISTRIBUTED GENERATION

- Whilst the approach for assessing the actual values appears reasonable, we continue to have concerns of how the expenditure associated with connecting generators will be defined

- It would be inappropriate to have different incentives depending on where a generator seeks to connect

- We welcome Ofgem's recognition that any incentive for ongoing network access needs to be proportionate to the incentive rate for connection.

- The objectives for IFI and RPZ are sound and agree with the views of respondents that the simpler mechanisms are needed

CHAPTER 6. ASSESSING COSTS

- Ofgem should publish the HBPQ and FBPQ submissions in full with the only exception being the publication of contractual information with third parties outside the group

- The results from top-down modelling using statistical techniques such as regression and data envelope analysis are only valid if costs have been normalised fairly for all DNOs, and the correct cost drivers are applied

- In respect of capitalization it is imperative that companies accounts are consistent with FRS15 as required by OFGEM following the report by Deloitte in March 2001. WPD's rationale for capitalisation is set out in detail in its report dated May 2002 that was sent to Ofgem in August 2002. .

- WPD supports transparency and bottom up modelling but OFGEM must get to the detailed level, as it was only when this level was reached when examining reliability that companies suddenly discovered that they were miscounting or not counting customer outages. It is vitally important that overhead costs are clearly identified rather than smeared across direct costs. Companies have no excuse for a lack of clarity if they are running their businesses effectively

- WPD supports the use of an average rather than a frontier approach as this places less weight on establishing which company is the true frontier, allowing for problems of cost normalisation

- WPD believes that detailed analysis of the operation of the distribution business is the best method of determining productivity changes in the future. Such analysis is also able to ensure that the cost of maintaining or improving quality of supply

and customer service standards, through for example tree cutting and line inspections, can be met

- £12.5m (in 1997/98 prices) represents a reasonable estimate of the level of fixed operating costs that a DNO can expect to save on merging with another DNO

- We consider that Ofgem should defer at this stage from making any adjustment to the RAV roll forward figure at 31 March 2005

CHAPTER 7. FINANCIAL ISSUES

- Pension costs should be included in the allowed income for DNOs, and WPD supports the principle that the allowed pension costs should be restricted to the price controlled activities to cover regulated distribution and metering business liabilities

- WPD supports Ofgem's pragmatic approach to pre-privatisation leavers. However, as a point of principle, WPD does not support retrospection prior to 1 April 2001 i.e. the effective date of the last triennial valuation.

- WPD reject your suggested approaches to calculating over/underfunding. We have no information as to what level of pension funding was included in the price control. In the absence of that information we are not in a position to agree to any calculation

- 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. This would be retrospective regulation.

- It would be appropriate 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

- Both customers and companies have benefited from staffing efficiencies and a calculation of their respective benefits gives a 70/30 split. Therefore if an allowance is proposed 70% of past ERDC's should be allowed for.

- In calculating the post tax cost of capital it would be inconsistent to use an assumed level of gearing in calculating the pre-tax cost of capital and then to revert to actual levels of gearing in calculating the tax charge. If the licencee is more highly geared than the assumed leverage then its shareholders retain the benefit of the tax shield on the excess in return for taking a higher risk on their equity. Conversely shareholders with gearing lower than that assumed receive the benefit of lower risk on their equity but pay more tax than assumed.

- Ofgem should assume the same level of gearing for all companies. The level of actual gearing should remain an issue for shareholders so that financing remains part of incentive regulation consistent with DPCR3.

- DNO's require continued access to capital markets to retain financial security. In order to retain this access they require, at a minimum, an investment grade (BBB- / Baa3) rating with a stable outlook. Therefore to the extent that triggers are deemed desirable by Ofgem the cash lock-up mechanism should be triggered at the point at which the licencee is downgraded to BBB-.

CHAPTER 3. FORM, STRUCTURE AND SCOPE OF THE PRICE CONTROLS

Views are invited on any of the issues raised in this Chapter and in particular on:

- **the form of the revenue driver and whether it should include a capacity component. In case of the latter, Ofgem invites stakeholders to submit detailed and quantified proposals of how this would work;**

We agree with Ofgem that the addition of a capacity component is likely to add complexity and be difficult to calibrate. The existing form of revenue driver has proved robust and has not introduced perverse incentives to encourage inefficient use of electricity. One area that will need consideration in setting the base year is the pattern of where Easter falls, as regulatory year 2004/05 will not contain an Easter holiday. This will mean that 2004/05 sales will be higher and 2005/06 sales lower than the actual trend in sales. Uncorrected, this will result in a loss of allowed revenue of around 0.5% over the price control period.

- **the appropriate treatment of NGC exit charges and wheeling charges, EHV charges**

We continue with the view that we have very limited control over NGC exit charges and hence these should continue to be a pass through item. We do not believe that this distorts incentives between the development of connection to the National Grid and development of local distribution networks, as developments at this level are significantly influenced by the ability to obtain planning consent and demonstrating that proposals are the most economic are an important part of this process. Additionally, NGC exit charges do not reflect the total cost of establishing a grid connection (as some costs are recovered in TNUoS charges) and the balance of these has been significantly changed by the recent approval of NGC's 'Plugs' charging arrangement.

We agree that EHV charges should be covered by the price control. At present, there is no incentive to rebalance charges between EHV and other charges where underlying costs change.

- **non-contestable connection charges and business rates;**

We are concerned by the suggestion that it may be appropriate to incentivise DNOs to manage rates more efficiently. The degree of control that a DNO has over the level of rates is at best extremely peripheral. Rates are agreed with the Valuation office every five years and thereafter are not in practice controllable. Whilst technically there appears to be an appeals mechanism in place, if the Valuation office sees revenues dropping it can revoke the appeals mechanism and replace prescription rates. Rates therefore should be a pass through item.

- **Ofgem's approach to dealing with uncertainty;**

We support the work undertaken last year by frontier Economics and believe it set out a sound basis for assessing uncertainty. Unfortunately that work has not been built upon. It is our view that for risks that are uncertain, (for example lane-rental charges or new safety related costs) there should be a formal mechanism that allows distributors to recover costs within the review period that have been reasonably incurred and have not been allowed for in price controls.

- **the treatment of overspend and the balance between incentives to invest and incentives for cost efficiency; and**

We agree that incentives should be set to encourage companies to seek realistic capex as part of the price control. In doing so, the likelihood of overspending capital allowances increases and a mechanism to fairly treat efficiently incurred expenditure needs to be developed. The suggestion of backdating the return on efficiently incurred overspends would be appropriate. We also agree with the proposal that rewards for capex efficiency should be linked to the size of the initial capex allowance.

- **the proposed approach to a separate metering control.**

3.98 Whilst valuing meter assets on a depreciated replacement value partially addresses the issue of losing the value of historic investment, it does not remove that risk. It therefore remains the position that this would constitute a change in regulatory expectation, which raises doubts in respect of the risk associated with all other such historic and future investment.

This issue would be fully addressed by including termination fees in any separate price control for MAP. This approach would also reduce the risk of wasteful early replacement of useful assets by giving clear commercial signals to customers, which they would take into consideration when making strategic decisions in respect of wholesale meter replacement. This is particularly relevant for pre-payment meters, the group of meters that have the highest relative residual value and the least potential for re-use.

3.104 Whilst supporting the concept of basing price caps for MAP on the provision of a "basic" domestic meter, the requirement to apply similar calculations to determine charges for industrial and commercial meters will also need to apply to domestic meters other than the "basic" meter.

In addition, there will need to be some recognition that an element of the charge will be based on fixed costs and that the price cap may need to be varied to reflect changes in volume if a DNO retains the obligation to provide services and cannot withdraw from the market if volumes are insufficient to cover costs.

This can be overcome by recognising that fixed costs associated with licence obligations can be recovered through DUOS charges if insufficient income is available from metering charges.

3.106 OFGEM has provided no detail in respect of the practical application of an average revenue cap to MOp. In the absence of such detail, it is difficult to envisage how such a mechanism would work with varying volume and mix of activities without recognising the relative costs of those different activities.

If that were so, then those differing activities would have to be separately priced, which would be similar in concept to MAP. Additionally, a price cap for MOp is no less practical than for MAP. There could be, for example, a price cap for the activity of "installing a basic domestic meter", with a requirement to determine all other activity charges in line with the calculations used to determine the price cap for the controlled activity.

In addition, there will need to be some recognition that an element of the charge will be based on fixed costs and that the price cap may need to be varied to reflect changes in volume if a DNO retains the obligation to provide services and cannot withdraw from the market if volumes are insufficient to cover costs.

This can be overcome by recognising that fixed costs associated with licence obligations can be recovered through DUOS charges if insufficient income is available from metering charges.

CHAPTER 4. QUALITY OF SERVICE AND OTHER OUTPUTS

Views are invited on any of the issues raised in this Chapter and in particular on:

- **the options for revising the GOSPs;**

The first stage of the customer satisfaction survey carried out by Ofgem has identified that, in general, customers appear highly satisfied with the quality of service they receive from their DNO. Furthermore, initial results indicate that only 4% of customers surveyed are willing to pay for improvements to the level of service that they currently receive.

WPD has responded to specific questions and scenarios on changes to the standard of performance arrangements as part of our response to the forecast business plan questionnaire. This includes, within the narrative section, a detailed assessment of the costs and benefits associated with the provision of additional services to business or priority service customers, the introduction of automatic payments and tightening of the existing standards in line with the proposals set out in Section 4.2 to 4.8 of the consultation document

The second stage of the survey should establish more clearly the exact relationship between the costs to put proposed new or tightened standards in place and the willingness of customers to pay for these improvements.

It is important that that any subsequent changes to the standards of service accurately reflect these findings.

- **the development of the outputs framework and quality of service incentive scheme;**

Scope of the output measures and financial incentives

Distinguishing Between Types of Customer

Distinguishing between types of customer can only be realistically achieved in relation to output measures that operate at the individual customer level.

Distinguishing between types of customer for the purposes of reporting performance for output measures associated with the entire customer base, such as the number and duration of supply interruptions, would not produce meaningful information. For example, two dissimilar types of customer, who are situated adjacent to one another, are likely to experience the same quality of supply. However, it is highly likely that aggregate reporting of output performance for each customer classification would show dissimilar quality of supply.

Un-metered Connections

It would not be cost effective to add un-metered connections to LV connectivity models. Therefore, the number of un-metered connections should not be included in the determination of performance for output measures associated with the entire customer base.

Worst Served Customers

We note that OFGEM intend to discuss this further with DNOs later this year and look forward to contributing to the discussions.

Disaggregated Performance

We agree that the data required to compare performance at a more disaggregated level, should now be included in the formal reporting requirements set out in the RIGs.

Form of the incentive for interruptions to supply

Symmetrical Scheme with Rewards and Penalties Each Year

We propose that it would be appropriate for the IIP incentive scheme associated with quality of supply to be developed into a symmetrical scheme with rewards and penalties applicable each year. However, it would be necessary to include a mechanism that eliminates or minimises random performance variability.

Major performance variability usually occurs as a result of an exceptional event, and always reflects an adverse impact on output performance. In order to eliminate or minimise major performance variability, it is essentially to maintain provisions for the exclusion of exceptional events.

Minor performance variability can occur as a result of differences in weather experienced, data errors and measurement errors. The elimination or minimisation of the effect of minor performance variability can be achieved through either the use of dead-bands or rolling average performance.

Use of Dead-bands

We propose that it would be appropriate to use performance dead-bands as a means of minimising minor performance variability. However, it is perceived that the use of performance dead-bands would dampen incentives. One way of overcoming this drawback would be to have a variable incentive rate. The table below illustrates the idea. DNOs would be incentivised to achieve the next performance band.

Performance band relative to target	**Incentive Rates (£k per unit)**
(-x% - 0%) and (0% - +x%)	nil

(-y% - -x%) and (y% - x%)	X
(-z% - -y%) and (z% - y%)	X + Y

Rolling Average Performance

The disadvantages associated with the use of rolling average performance outweigh the advantages. In particular, poor performance in one year would make it difficult to meet targets for several years and therefore incentives would be weakened.

The use of dead-bands is preferable to the use of rolling average performance.

Targets, incentive rates and financial exposure to the incentive scheme

In principle, quality of supply improvement targets, incentive rates and total financial exposure should take into account the customer's willingness to pay. However, when developing the quality of supply improvement targets it is essential to take into account the costs associated with delivering the targets.

It would be appropriate to maintain the current level of total financial exposure.

Planned interruptions in final year of the current scheme

The way targets were set at the last Review has resulted in the perverse incentive for the deferment of planned work during 2004/05. Some companies have received massive (over 100%) adjustments to their target figures from those original proposed. The most appropriate means of addressing the perverse incentives associated with the deferment of planned works during 2004/05, would be to allow DNOs to "roll forward" a proportion of their planned interruption performance from 2004/05 into 2005/06.

The work on comparing quality of supply has confirmed the severity of the 2004/05 quality of supply targets for WPD (South West). Given our projected mid point forecast quality of supply performance for 2004/05, we would envisage opting to use the "rolling forward" principle for WPD (South West).

- **the approach to network resilience;**

Existing incentives relating to network resilience

Any requirement to improve network resilience would need to be first subject to Regulatory Impact Assessment, with the costs associated with improving network resilience subsequently factored into the price control.

Improving the ability of the network to withstand severe weather

Three options for incentivising improvement in the ability of a network to withstand a severe weather event have been considered in the consultation paper.

The first option is to use an outputs based approach. It is extremely difficult to define an output that measures robustly the ability of a network to withstand a severe weather event. Consequently, until a reliable relationship can be established between an exceptional weather event and the damage to a network, it would not be feasible to define an output measure.

The second option is to use an inputs based approach. This would involve the monitoring of one or more work inputs that are targeted at improving the ability of a network to withstand a severe weather event. However, such monitoring would not be appropriate as it would reflect a move towards intrusive regulation and would not necessarily bring about an improvement in the ability of a network to withstand a severe weather event.

The proposed removal of exceptional events from IIP outputs effectively destroys the rationale for establishing IIP. It is important that company's performance is compared on a level playing field that excludes distortion. This option is illogical and the consequence of it's application perverse. A company could perform exceptionally well during a severe weather event, as WPD did during the October 2002 storms, but then be financially penalised. The removal of the exclusion of exceptional events from the financially incentivised IIP output measures would not promote improvements in the ability of a network to withstand severe weather events.

There is currently no effective means of incentivising improvement in the ability of a network to withstand a severe weather event.

Ability of a company to respond to a severe weather event

Three options for incentivising improvement in the ability of a company to respond to a severe weather event have been considered in the consultation paper. The options considered are:

- The use of a restoration time profile, whereby targets are set for the number of customers (or percentages) to be restored within defined periods;
- An ex-post performance assessment; and
- The removal of the exclusion of exceptional events from the financially incentivised IIP output measures.

It is widely recognised that no two severe weather events are the same. Therefore it is unlikely that it would be feasible to define a restoration time profile in advance for each severe weather event. For the reasons outline above, the removal of the exclusion of exceptional events from the financially incentivised IIP output measures would not promote improvements in the ability of a company to respond to a severe weather event. The most realistic option is the ex-post performance assessment.

An incentive mechanism should be introduced whereby companies are rewarded (penalised) for good (poor) performance during a severe weather events.

Set against an understanding of the scale of the severe weather 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.

Companies' performance could be scored against the selected criteria. Good performers would be rewarded and poor performers penalised. It would be possible to undertake an objective evaluation even if only one company is affected.

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.

Management of communications during an event

Two options for incentivising improvement in the management of communication during a severe weather event have been considered in the consultation paper. The options considered are:

- Allowing no exclusions from the general telephony incentives; and
- An ex-post performance assessment.

The performance of the telephone infrastructure is not under the direct control of companies, for example, during October 2002, some companies experienced difficulties as a consequence of the failure of BT equipment. The most realistic option is the ex-post performance assessment.

- **revising the telephony incentives; and**

We agree that there appears to be an inherent bias in the consumer survey. All safety and security telephone calls for WPD South West and WPD South Wales are handled at one call centre. There is no distinction between the way in which these calls are routed or handled. Operators deal with all calls for either company, as they arrive, using one process. Throughout the year there has been a marked difference in the performance of the two companies with as much as four places difference between the rankings in the monthly league table of all DNOs. We have also noticed big variations in the monthly results. For example, in June 2003, WPD South West fell from joint second in the league table to 7th position and WPD Wales fell from joint 2nd to 11th. We are struggling to understand these changes and believe there may be a number of reasons such as: differing customer expectations between South West and South Wales customers, the form of the

survey and the questions asked, the sample of customers provided (see comments on messaging systems below) or the calculation of the results. We therefore support the additional work proposed to investigate this further.

We agree with the proposal that customers who receive an automated telephone response should be included in the survey to provide a balanced view from all customers. In WPD we have recently introduced a sophisticated messaging system, which plays a customer a tailored, specific message and allows them to automatically register when they call in to report a no supply. Our own customer survey indicates a high level of satisfaction and acceptance of the message, with typically 70% of all customers contacting us using the automated system. This potentially means that the survey sample provided to Accent, which is based on customers who speak to an operator only, is a small subset of all customers contacting WPD. It is possible that this subset of customers represents a biased sample that may be less satisfied than the majority who have received the message and chosen not to speak to an operator. .

Provided the issues outlined above can be addressed, true comparisons can be made between DNOs and then the survey incentive could be continued on a relative basis. If results continue to converge at a relatively high performance level then DNOs' performance could be assessed against a predetermined level or target as suggested in 4.37

With regard to the existing information provided on speed of telephone response, we agree that it is difficult to collect comparable data in this area. In particular, we do not support the current proposal to treat a system that allows a customer to wait to speak to an agent in the same way as a system that requires a customer to re-dial a separate number to talk to an operator. In order to make equitable comparisons, we support the suggestion therefore, that there is merit in combining the quality and speed of telephone response into a single measure monitored by additional questions in Ofgems' monthly survey.

- **introducing environmental outputs reporting**

WPD's Historical BPQ Narrative (G1) gave a detailed account of its approach to the development of environmental reporting, and makes reference to Ofgem previous statements on the subject. WPD has historically reported, through the former Electricity Association, system losses, fluid lost from fluid filled cables, SF6 in use and SF6 lost, road excavation to landfill, and environmental prosecutions. We have also developed internal systems following previously issued DEFRA guidelines data on greenhouse gas emissions related to various WPD activities.

We have estimated that the costs of the collection, aggregation, calculation and publication (on our website) of such data would be around £10,000 p.a.

The imposition of additional reporting requirements needs to be considered very carefully to check that there is a real and justified need, and they are not simply there "for

appearance". The above items reported through the former EA, were established following an extensive dialogue with a number of stakeholders, and it is recalled that Ofgem were represented at an open meeting with those stakeholders on 5th July 2000. Following that consultation with stakeholders, Ofgem " favoured the development of a small number of key performance indicators" (Ofgem Environmental Action Plan Aug 2001 (7.13)). The same document (7.5) stated " The study showed a strong resistance on the part of the companies to mandatory public environmental reporting requirements…, The companies described the industry as an already "heavily regulated" sector "

It is concerning to see reference to reporting " visual amenity including heritage and landscape" as such issues are already heavily covered by legislation, planning controls and regulation. It suggests a lack of understanding of measures already in place, illustrated by the following list of applicable legislation –

- Ancient Monuments and Archaeological Areas Act 1979
- Contaminated Land (England) Regulations 2000
- Electricity and Pipe-line Works (assessment of Environmental Effects)
- Regulations 1990
- Electricity Works (Environmental Impact Assessment) (England & Wales)
- Regulations 2000
- Environmental Protection Act 1990 & 1995
- EU Habitats Directive 92/43/EEC – Special Areas of Conservation
- Land Drainage Act 1991
- Noise at Work Regulations 1989
- Town & Country Planning Act – General Development Order 1990
- Water Resources Act 1991
- Wildlife and Countryside Act 1981
- And draft legislation such as the EU Directive on Flourinated gases

CHAPTER 5. DISTRIBUTED GENERATION

5.71. Views are invited on any of the issues raised in this Chapter and in particular:

- **the approach for assessing and the actual level of the initial values for both the pass-through and the incentive rate under the incentive framework for distributed generation;**

The DG BPQ was completed on the basis of 'sole asset' being those assets up to the point of common coupling at the time of connection. Hence we welcome Ofgem's decision that these assets will form part of connection charges to generators.

Whilst the approach for assessing the actual values appears reasonable, we continue to have concerns of how the expenditure associated with connecting generators will be defined. For example, where switchgear needs to be replaced will some of the costs be classified as betterment and allocated to non DG related investment prior to assessment of how much is pass through? Judgments in this area are likely to result in greater uncertainty and greater regulatory intervention in future.

- **whether incentives should be provided for strategic investment, and if so, the best way of doing so;**

We have not identified an appropriate incentive for strategic investment other than the suggestion of increasing the incentive rate. In reality, the risk is unchanged by increasing the incentive rate and hence is unlikely to result in a greater incentive.

- **whether DNOs should be given the option to choose the level of passthrough (and associated incentive rate) proposed by Ofgem;**

We believe that it would be inappropriate to have different incentives depending on where a generator seeks to connect. If it is an incentive then applying it to different levels will result in differing behaviours.

- **the provision of incentives for ongoing network access;**

We welcome Ofgem's recognition that any incentive for ongoing network access needs to be proportionate to the incentive rate for connection. The level of compensation rate needs to be pitched so that an efficiently operated distributor will still be able to exceed the rate of return on other investment.

- **the appropriateness of the IFI and RPZ initiatives, including whether the objectives are sound; and**

We believe that the objectives for IFI and RPZ are sound and agree with the views of respondents that the simpler mechanisms are needed.

- **whether the IFI and RPZ initiatives will be cost-effective for consumers.**

We believe that they may help achieve Government targets for connecting distributed generation and can result in lower connection costs.

CHAPTER 6. ASSESSING COSTS

6.91. Views are invited on any issues set out in this chapter and in particular on:

- **publication of DNO information;**

The publication of DNO information must improve the review process for all interested parties; we therefore consider that Ofgem should publish the HBPQ and FBPQ submissions in full with the only exception being the publication of contractual information with third parties outside the group

- **cost normalisation issues;**

The results from top-down modelling using statistical techniques such as regression and data envelope analysis are only valid if:

1. costs have been normalised fairly for all DNOs, and
2. the correct cost drivers are applied

WPD recognise that Ofgem have made some progress on the normalisation of the 2002/03 base year operating costs but clearly the process is not complete in several areas including:

1) Company Specific Factors – all DNOs are likely to have some specific factors, which should be taken into account when normalising costs. We will write to Ofgem separately on the factors which are unique to WPD's operating area and their cost impact

2) Overheads and IT costs – It is vitally important that overhead costs are clearly identified rather than smeared across direct costs. Companies have no excuse for a lack of clarity if they are running their businesses effectively. We consider that these costs should be identified for all DNOs because they:

   a. represent a significant proportion of a DNO cost base

   b. are largely fixed and thus represent a higher proportion of costs for a smaller DNO and vice-versa

   c. distort benchmarking if not transparent

   d. distort opex and capex levels if the proportion capitalised is not consistent across DNOs

3) Faults – the fault costs shown in the data and costs commentary appendix indicate a large variation in the boundaries that DNOs have identified as faults and significant differences in the proportions capitalised

   For consistency there ideally should be a central definition of faults, which can then be applied by all DNOs in the same way.

WPD proposed a definition of faults to Ofgem in May 2002, which we have applied in 2002/03. This definition in essence is that a fault is due to network failure whether as a result of weather or as a result of failure of materials (e.g. a pole collapses). Subsequent work arising from the fault that:

- replaces part of the network i.e physical faults ; the expenditure thereon should be capitalised and categorised as "capitalised faults"

- involves no replacement i.e. non-physical faults ; the expenditure thereon should be expensed and categorised as "expensed faults"

WPD believes this distinction is relatively simple and could be applied in the future by Ofgem to derive consistency. However, we recognise that this will probably be unachievable for the current review.

We therefore propose that Ofgem focus on ensuring that faults in total have been captured by all DNOs consistently in line with the WPD definition. The implication of this is that some DNOs should be asked by Ofgem to re-appraise their capex schemes and whether they are fault related. Only on completion of this fault cost normalisation exercise can fault benchmarking begin.

We further propose that in the absence of consistent costing information, that for this review total faults are funded 50% through opex and 50% capex.

In respect of capitalization it is imperative that companies accounts are consistent with FRS15 as required by OFGEM following the Deloitte report

With respect to cost drivers we welcome as a move in the right direction one of the CEPA report conclusions that 75% of controllable operating cost are network length driven. In our opinion, customers drive less than 2% of controllable operating costs.

- **Ofgem's approach to bottom up modelling;**

WPD supports transparency and bottom up modelling but OFGEM must get to the detailed level, as it was only when this level was reached when examining reliability that companies suddenly discovered that they were miscounting or not counting customer outages The fundamental business of a DNO is to maintain, renew, extend and operate the assets of a distribution network. Bottom up modelling of costs is based on the level of assets and the associated repair and maintenance activities. A bottom up model must aim to capture the factors that affect the costs of a distribution network including any local considerations. It is clear that any bottom up model must be made up of a set of viable activities rather than Cherry-picking the lowest cost option from each company.

The treatment of overheads or indirect costs could significantly distort the results of a bottom up analysis and so in WPD's view these costs should be considered separately.

As we commented previously statistical/econometric benchmarking techniques may provide useful back-up information but these techniques are secondary to bottom up modelling.

WPD supports the use of an average rather than a frontier approach as this places less weight on establishing which company is the true frontier, allowing for problems of cost normalisation. An average approach only delivers the average rate of return spread over all the companies involved and maintains an incentive for all companies to improve their performance.

- **CEPA's TFP productivity study;**

Ofgem have stated that they "will use the productivity study….. and it will be important to understand how the productivity growth figures translate into allowed revenue figures." Although attempting to provide for transparency there is no information about how the CEPA report's recommendations will be translated into values in the DPR consultation.

Under the cash flow methodology used in the last price control review the choice of X factor only serves to phase the total amount of allowed revenue over the 5 years of the price control. The income stream is adjusted to give the same NPV depending on the choice of X. Consequently the application of the TFP study is of limited significance.

However, if the output of the study is used to determine efficiency savings applicable to operating costs as an input to the cash flow model this will have too significant an effect.

WPD believes that detailed analysis of the operation of the distribution business is the best method of determining productivity changes in the future. Such analysis is also able to ensure that the cost of maintaining or improving quality of supply and customer service standards can be met.

CEPA in their November report have noted a number of shortcomings with the productivity analysis as it currently stands. In particular the lack of convergence between DNO's make the use of an average efficiency improvement figure seem invalid. The report shows a very wide range of performance by different companies with little evidence of any general lessons that can be learned.

The results in the report also make use of a number seemingly arbitrary assumptions, such as the choice of a scale variable. It is not clear why the German utilities aggregate TFP trend should have been chosen for the lower bound of the forecast range rather than for example the Norwegian figure or why the mid-range figure is chosen rather than looking at the most reliable value. The range for future productivity growth looks high when compared with values for other mature distribution businesses.

The two elements of the CEPA report that are forward looking are the analyst views and the company survey. The former provides a median productivity growth estimate of 1.4%, which is well below the 2.4% central estimate quoted in CEPA's conclusion.

The values quoted in the company survey show productivity growth expectations of 2.3%, which seems to back up the CEPA forecast. However these growths may be the result of transferring activities to other countries with lower costs or from technological improvements. These options are either unavailable to, or of very limited scope in the UK distribution business and so are of little or no value in deciding future productivity gains by DNO's.

- **approach to the price control treatment of mergers that occurred before June 2002;**

  We concur with Ofgem's view in DPCR 3 that £12.5m (in 1997/98 prices) represents a reasonable estimate of the level of fixed operating costs that a DNO can expect to save on merging with another DNO.

  For comparability purposes on the basis of 14 DNOs we suggest that for each DNO merger a £12.5m adjustment be added to the costs of the merged group.

  With the benefit of our experience in acquiring Hyder, WPD assimilated the South Wales distribution business in a little over six months from the date of acquisition. As 2002/03 is the base year, we would therefore suggest that for DNO mergers pre October 2001 that the full £12.5m is added back for comparability purposes, and for DNO mergers since October 2001 Ofgem should take a proportionate view of the adjustment.

  In our opinion the retention of merger savings for a period of five years and the £12.5m value is the preferred methodology. This is because:

  1. the £12.5m is backed-up by the cost evidence
  2. the retention of savings for five years is compatible with the rolling opex methodology

- **Ofgem's approach to the roll-forward of the RAV.**

We consider that Ofgem should defer at this stage from making any adjustment to the RAV roll forward figure at 31 March 2005. This is because the fault normalisation process, referred to above, should flush out some of the definitional issues, which need to be ironed out before finalising any adjustments.

We understand Ofgem's concern that customers should not be expected to pay twice in capex and opex. However, we believe that in 1997/98 WPD were probably capitalising

less faults than the frontier company. This is of necessity a subjective opinion because we have no costing information on faults with respect to other DNOs in 1997/98, and even if we did there would remain the definitional issue of faults.

Thus as the WPD opex allowance was based on the frontier company it is difficult to understand how WPD customers could be paying twice, particularly as we had no fault adjustment to increase opex.

For DNOs in a similar position to WPD on this issue, we propose that once the definitional issues have been resolved, that up to 50% of total faults be allowed in capex. This would then be consistent with our proposal for the funding of fault expenditure in the next price control period.

CHAPTER 7. FINANCIAL ISSUES

7.90. Views are invited on any of the issues raised in this Chapter and in particular on:

- **The type and level of trigger that would be appropriate for the cash lockup mechanism;**

DNO's require continued access to capital markets to retain financial security. In order to retain this access they require, at a minimum, an investment grade (BBB-/ Baa3) rating with a stable outlook. Therefore to the extent that triggers are deemed desirable by Ofgem the cash lock-up mechanism should be triggered at the point at which the licencee is downgraded to BBB-

- **Whether Ofgem should adopt a post-tax approach to the cost of capital and whether this should be an industry-wide cost of capital with company specific tax allowances directly incorporated into the financial model**

WPD supports the use of a post tax cost of capital. In calculating the post tax cost of capital it would be inconsistent to use an assumed level of gearing in calculating the pre-tax cost of capital and then to revert to actual levels of gearing in calculating the tax charge. If the licencee is more highly geared than the assumed leverage then its shareholders retain the benefit of the tax shield on the excess in return for taking a higher risk on their equity. Conversely shareholders with gearing lower than that assumed receive the benefit of lower risk on their equity but pay more tax than assumed. Other tax effects could be dealt with on a company-specific basis.

- **Whether Ofgem should adopt an assumed level of gearing which reflects the increase in average gearing, and if not, why not.**

Ofgem should assume the same level of gearing for all companies. The level of actual gearing should remain an issue for shareholders so that financing remains part of incentive regulation consistent with DPCR3.

7.91. Ofgem would also like to hear the views of stakeholders on the proposed treatment of pensions, and in particular in relation to:

- **the allocation between price-controlled and non-price-controlled activities;**

WPD reaffirms its agreement with Ofgem's principle that recognition of pension costs should be included in the allowed income for DNO's, and supports the principle that the allowed pension costs should be restricted to the price controlled activities to cover regulated distribution and metering business liabilities.

In terms of commenting on the detail in the consultation document WPD would supports Ofgem's view that the liability relating to active members be allocated according to their present employment.

In terms of allocating liability relating to post-privatisation leavers Ofgem's view is that this should be allocated according to the employment in which the employee served immediately prior to leaving service. It would not be possible for WPD to badge post-privatisation leavers on an individual basis as we do not have historical data for South Wales. We could broadly allocate total liabilities for South Wales based on South West data. As information will vary from DNO to DNO inconsistencies with this proposal is inevitable and a more pragmatic approach, similar to that that being suggested by Ofgem for pre-privatisation members, would therefore be suggested.

WPD supports Ofgem's pragmatic approach to pre-privatisation leavers however as a point of principle does not support retrospection prior to 1 April 2002 i.e. the signing off of the 2001 valuation results.

WPD would comment that the allocation of pension fund assets should be in proportion to liabilities. An allocation based on a matching assts approach would not, in our view, be practical or possible to achieve with any degree of accuracy.

- **the options in relation to the treatment of over/under provision; and**

On the question of over or under provision WPD reject your suggested approaches to calculating over/underfunding. We have no information as to what level of pension funding was included in the price control (as opposed to our submission at the time). In the absence of that information we are not in a position to agree to any calculation.

- **the treatment of early retirement deficiency costs.**

On Early Retirement Deficiency Costs, we continue to 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.

Customers have benefited, and continue to benefit, from efficiencies achieved through staffing reductions. Indeed, customers have already benefited more than the licencee in some cases. 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 cost to groups of early retirements can be distorted by funding assumptions and therefore some DNO's ERDC's may be 'artificially lower' and therefore not directly comparable

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.

In conclusion, whilst WPD believes that the distribution element of pensions costs should to be reflected as a pass through cost, WPD recognises that it is more likely that Ofgem will set some form of allowance.

If this is so, then WPD is strongly of the view that the complexity of pensions and the fact that pension group costs are not directly comparable across DNO's should lead Ofgem to extend their recognition in the consultation paper that a pragmatic approach to apportionment of liabilities be extended to other areas of pensions - specifically to the treatment of early retirement deficiency costs.

In this regard, we believe that Ofgem should recognise the true benefit to customers from the staffing efficiencies already achieved which we calculate, broadly, in npv terms equate to a 70/30 split in favour of the customer. Therefore 70% of past ERDC's should be allowed for. It also follows to WPD that retrospection prior to 1 April 2002 i.e. the signing off of the 2001 valuation results, would penalise DNO's who have managed, in the absence of Ofgem conditions, large pension scheme surpluses for the benefit of both the Company and the customer.

WPD would support Ofgem with the type of approach outlined which we believe gives Ofgem, customers and DNO's a fair and pragmatic solution.