

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW
UPDATE PAPER
RESPONSE BY WESTERN POWER DISTRIBUTION**

CHAPTER 2 METERING

The mechanism proposed by Ofgem to deal with premature replacement of prepayment meters still leaves an unacceptable risk to DNOs that they will not be able to recover investments made under licence obligations. There is no evidence to support Ofgem's assertion that Termination Charges could have a negative effect on the development of competition in metering. It remains our view that Termination Charges are the only mechanism that adequately balances the decision to replace prematurely with the cost of doing so.

A 1.5% mark-up is inappropriate to a business of the nature of MOp. The nearest equivalent business would be that of an electrical contractor where a mark-up of between 10 and 20% would be expected.

We do not consider the June 2003 contracts to be sufficiently robust to maintain the mix of appointment notice periods and time bands. We therefore support the determination by Ofgem of the basic service with any variations to that being outside the price control.

We are not in a position to comment on the proposed Average Revenue Cap for MOP, because Ofgem have not completed their policy work and insufficient information is available to estimate prospective income. WPD considers this to be an unacceptable position at this stage of the review.

CHAPTER 3 QUALITY OF SUPPLY AND OTHER OUTPUTS

Proposed Approach for Interruption Audits

Ofgem's proposal to adopt a streamlined audit of incidents is welcomed. However, it is not clear that the proposed two part approach to the audit of incidents will actually result in materially lower costs for:

1. Ofgem, as this will be dependent on the contractual relationship between Ofgem and the appointed auditors; and
2. DNOs, as the vast majority of a DNO's costs are incurred in preparation for the audit.

Very Large Severe Weather Exceptional Events (Category 3)

We have two concerns relating to the proposals for very large severe weather exceptional events.

First, the proposal to use a linear sliding scale formula, based on the number of customers affected, to determine the initial trigger period for compensation payments does not model practical experience. During any severe weather event, the relationship between the number of customers affected and the time taken to restore supplies is not linear. The relationship is almost exponential. Therefore, it would be more realistic to determine the initial trigger period for compensation payments using a formula that incorporates a square law function.

Second, there is no upper limit to the scale of a very large severe weather event. This is in contrast to the existing Standards of Performance regulations and the interim arrangements for the impact of severe weather. Whilst very large severe weather events occur infrequently, most recently in 1987 and 1990, the extent of the damage caused can extend repair times. Consequently, we suggest that it would be prudent to introduce an upper limit equal to 70% of exposed customers. For both WPD (South Wales) and WPD (South West) 70% of exposed customers equates approximately to 40% of total customers. Therefore at this upper limit, 60% of the total customer base who were unaffected by the very large severe weather event could be contributing to compensation payments.

One Off Exceptional Events (Not Weather Related)

Ofgem have proposed thresholds for one off exceptional events that are not weather related. The proposed absolute thresholds, which are uniform across all DNOs, are 25,000 customers affected and 2 million customer minutes lost.

The use of uniform absolute thresholds for all DNOs is not equitable. As shown in the table below, the 25,000 customers affected threshold, when expressed as a percentage of the 2009/10 customer interruptions targets ranges from 0.8% (EDF-EPN) to 3.6% (SP MANWEB), with an average of 1.6%. A more equitable approach would be to use thresholds that translate into uniform percentages of the 2009/10 customer interruptions targets.

| | Absolute Customer Interruptions Threshold | Equivalent Customer Interruption per 100 Customers | 2009/10 CI Target | Threshold as Percentage of Target |
|--------------------|---|--|-------------------|-----------------------------------|
| CN (West Midlands) | 25,000 | 1.1 | 103 | 1.1% |
| CN (East Midlands) | 25,000 | 1.0 | 76 | 1.3% |
| United Utilities | 25,000 | 1.1 | 57 | 1.9% |
| CE - NEDL | 25,000 | 1.6 | 75 | 2.1% |
| CE - YEDL | 25,000 | 1.2 | 68 | 1.8% |
| WPD (South West) | 25,000 | 1.7 | 84 | 2.0% |
| WPD (South Wales) | 25,000 | 2.3 | 94 | 2.4% |
| EDF (LPN) | 25,000 | 1.1 | 36 | 3.1% |
| EDF (SPN) | 25,000 | 1.2 | 83 | 1.4% |
| EDF (EPN) | 25,000 | 0.7 | 84 | 0.8% |
| Scottish Power | 25,000 | 1.3 | 61 | 2.1% |
| MANWEB | 25,000 | 1.7 | 47 | 3.6% |
| SSE - Hydro | 25,000 | 3.7 | 95 | 3.9% |
| SSE - Southern | 25,000 | 0.9 | 87 | 1.0% |
| Total | 350,000 | 1.2 | 74 | 1.6% |

Exceptional Event Allowances

The exceptional event allowances do not appear to be equitable across DNOs. As shown in the following table, the exceptional allowance per exposed customer and per Km of overhead line for WPD (South West) are both lower than their corresponding industry averages, yet the South West experiences greater risk. In this context risk is measured as:

1. Exposed customers as a percentage of total customers; and
2. Overhead line as percentage of total network length.

For WPD (South West), both these parameters are markedly higher than their corresponding industry average.

| | Allowance per Exposed Customer | Allowance per kM Overhead Line | Exposed Customers as Percentage of Total Customers | Overhead Lines as Percentage of Total Network Length |
|-------------------------|--------------------------------|--------------------------------|--|--|
| CN (West Midlands) | £2.3 | £95.1 | 44% | 40% |
| CN (East Midlands) | £2.0 | £98.3 | 47% | 34% |
| United Utilities | £1.7 | £95.0 | 33% | 23% |
| CE – NEDL | £3.1 | £125.7 | 40% | 38% |
| CE – YEDL | £1.6 | £115.0 | 48% | 23% |
| WPD (South West) | £2.1 | £55.6 | 52% | 60% |
| WPD (South Wales) | £3.4 | £109.7 | 54% | 54% |
| EDF (LPN) | | | | |
| EDF (SPN) | £1.4 | £85.2 | 39% | 26% |
| EDF (EPN) | £2.4 | £94.4 | 39% | 38% |
| Scottish Power | £2.8 | £73.6 | 34% | 37% |
| MANWEB | £2.2 | £55.7 | 37% | 46% |
| SSE – Hydro | £4.1 | £44.9 | 50% | 67% |
| SSE – Southern | £2.3 | £97.0 | 43% | 37% |
| Total | £2.3 | £84.4 | 42% | 39% |

Consequently we propose that the exceptional event allowance for WPD (South West) should be increased in order to ensure that the allowance is consistent with the degree of risk.

Losses

WPD confirms the views expressed in our response to the June consultation paper. These can be summarised as:

1. The increase in the incentive rate adds significantly to the short term risk of the company because of the increased impact of factors such as changes to EHV sales and further deterioration in the operation of the settlements system, both of which are outside the control of DNO's.
2. The target level of losses is weighted too heavily towards recent history, thus producing a target that is not a true 10-year average. The estimated cost of this difference is £5m to WPD during the course of a 5-year price control.

CHAPTER 4 COST ASSESSMENT

Cost Assessment

As discussed in our response to the June document, WPD disagree with the methodology used in the operating cost assessment. We look forward to working with Ofgem to produce auditable direct cost classifications and the associated cost drivers by DNO activity.

Regional Factors

The cost of generation support to the Scilly Isles should be taken into account as a regional factor because the cost of about £1m of ensuring a standby facility is not included in our cost allowance as it was added to the normalised costs and then removed in the regression. This cost of about £1m only covers the cost of ensuring that a standby station remains on the islands. The supply to the islands is via a single 33kv cable at the end of its design life and so WPD carry the fault risk for energy supplied in the order of £1.1m per fault repair. This risk could be dealt with in one of two ways - as pass through or via an additional allowance. It should be noted that the combined cost of the station plus the fault risk is significantly lower than the cost of a installing a second submarine cable. This cost is not included in our cost allowance because it was added to the normalised costs and then removed in the regression and hence needs to be allowed as a special factor.

The September paper suggests that SPN's costs should be adjusted by £3M due to higher wage costs in the South East. This is not supported by the analysis in Appendix 1 which show craftsman wage rates at SPN as 6.4% below the UK DNO mean. However if a company employs large numbers of highly paid staff under the general banner of overheads then average wage costs across the business will appear to be high.

The sparsity of WPD's network provides a better fact-based reason for regional allowances than the arguments by London and SPN for regional allowances for salary costs. WPD estimate that an additional £5m should be added to our cost allowance. These additional costs include:

- a) £1.1m for the additional transport costs associated with serving twice the number of substations per customer, and 1.22x the network per customer. (including the cost of specialist vehicles required for the territory).
- b) £0.7m for the impact of salt corrosion on the number of faults as a result of having a largely coastal network
- c) £1.2m for the additional fault costs incurred as a result of Consac cable. (Consac cable is twice as likely to fault and the costs of dealing with such additional faults is excluded from the upper quartile "opex plus faults" allowance).

Frontier Shift

We consider that the 1.5% per annum cost saving expectation is arbitrary and takes no account of real DNO potential cost savings and increases. For example, changes in government legislation include the likelihood of a companies being required to make contributions to a Pension Protection Fund. We have strong reservations about the robustness of the upper quartile allowance cost base, so adding further annual cost savings exasperates this lack of robustness. Ofgem should assume no future cost savings.

Capital Investment

We welcome the acceptance of our arguments on diversions and investment needs for LV overhead lines prior to 2008. We also welcome the confirmation of a reopener to assess the cost of compliance with the ESQCR's after the overhead line survey has been completed in 2008.

Incentive regime

We welcome the further development of the proposed sliding scale incentive and the sharpening of the incentive for companies to submit realistic forecasts of investment needs. We still believe that a number of companies are being given allowance significantly in excess of their needs if they were run along efficient lines.

We are also concerned that it is proposed that the incentives for Opex are reduced prior to an agreement on definitions of cost categorisation. We urge Ofgem to prioritise this categorisation work so that the incentive can be restored.

CHAPTER 5 FINANCIAL ISSUES

WACC

WPD supports the points set out in the ENA letter sent to Ofgem on October 8th.

In particular, our experience of actual cost of equity requirements of investors indicates that there are no investors for DNO assets prepared to accept a post tax nominal cost of equity below 11%.

RAV Roll-forward

Three adjustments made in the RAV roll forward calculation are inappropriate and should not be adjusted for. The stated basis of these adjustments is to reset the RAV according to capitalisation policies agreed for DPCR3. No basis of capitalisation was agreed as part of DPCR3. In May 2004 Ofgem circulated what was said to have been agreed but this had not previously been made available to WPD. Further, in August 2002 WPD submitted a detailed report on capitalisation to Ofgem that we have yet to receive comments on. The report, that was reviewed and approved by both Ernst & Young and Pricewaterhouse Coopers, concluded that WPD was undercapitalising corporate overheads.

The following adjustments to the RAV included in the September paper are incorrect:

1. **Corporate Costs** (£7m adjustment to RAV): In August 2002 WPD submitted a detailed report on capitalisation to Ofgem that we have yet to receive comments on. The report, that was reviewed and approved by both Ernst & Young and Pricewaterhouse Coopers, concluded that WPD was undercapitalising corporate overheads when compared to the guidance received from Ofgem as part of the review of capitalisation undertaken by Deloitte published in later 2001.
2. **Indirect costs** (£17m adjustment to RAV): the amount of indirect costs capitalised by WPD has not changed significantly as a proportion of gross capex. This adjustment is made because it measures the variation of a non-capex cost to make an adjustment to capex. The adjustment is therefore incorrect because it is neither in accordance with Ofgem's guidance from the last review nor is it calculated on a logical basis.
3. **Transport depreciation** (£11m adjustment to RAV): This adjustment purports to reverse the depreciation of vehicles from capex, because vehicle costs were treated as opex (non-operational capex) in DPCR3. However, because no vehicle additions were included in non-operational capex for DPCR3 the adjustment is not required.

Pensions

Deficit Repair - We note that Ofgem continue to use an average remaining service life of 13 years pending further information from companies but that Ofgem are disallowing 1/13th of the deficit to account for contributions made in 2004/05. Payments into the fund in respect of the 2004 deficit should not commence until after March 2005 and therefore all deficit funding falls within DPCR4. (The issue is further compounded by spreading the remaining deficit over 13 years rather than 12 from the start of the price control period.)

Pension Protection Fund Levy whilst uncertain at this time, this is quite a significant sum over the DPR period. We suggest therefore that there is agreement in principle to treat any such costs that may arise as pass-through items as they occur within the 5-year price control period.

Tax - Opening balances

There are two issues with the opening balances:-

1. Ofgem have stated that they have taken the opening position from the submitted 2002/3 computations, however this is not correct. In the case of both WPD companies the values used by Ofgem are higher for all pools of expenditure.
2. The same assumptions of capital expenditure split have been used to calculate the opening position at March 2005 as in the June model. We pointed out that these assumptions were incorrect based on our pattern of expenditure and submitted our calculations that showed, in particular, a decrease to the long life asset pool at March 2005 of £46m in the South West and £28m in South Wales. These differences are not the result of group tax strategies or non-distribution assets but are due to the incorrect allocation of expenditure by Ofgem to get to the March 2005 position and we are of the opinion that adjustment should be made for this.

Tax - Categorisation of costs for tax purposes

Allowance in the model seems to have been made for the increased deferred revenue expenditure but the adjustment for non-qualifying and plant and machinery spend does not reflect our actual position as explained to Ofgem.

Tax - Incentives and risk sharing

The revenues for incentives are still being excluded from the tax charge, thereby misstating the cash taxes payable.

Whilst we acknowledge the principle of sharing the benefit of an improved tax position, we do not know the methodology for doing this and, if the base case is not sufficiently robust, this will penalise the business.

DETAILED TABLES AND PRICE CONTROL CALCULATIONS

We consider that the mixing of real and nominal interest rates and the inter-relationship with the rate of inflation under-states the derived revenues. We requested the consultants engaged to audit the financial model prior to Final Proposals (para 5.55) addressed this issue in conjunction with WPD.

Comparative Craft Rates in the Electricity Industry From IDS Article Pay in the Electricity Sector 2001****'Mid' Table**

| Company | 1 April 2003 | | |
|---------------------------|--------------|-----------|-----------|
| | Min (£pa) | Max (£pa) | Mid (£pa) |
| London Electricity | 16,248 | 21,242 | 18,745 |
| Norweb | 17,698 | 19,074 | 18,386 |
| East Midlands Electricity | 16,100 | 19,614 | 17,857 |
| Southern Electric | 15,760 | 19,498 | 17,629 |
| Manweb | 14,942 | 20,310 | 17,626 |
| Midlands Electricity | 15,777 | 19,458 | 17,618 |
| Eastern Electricity | 15,185 | 19,907 | 17,546 |
| WPD (South Wales) | 15,140 | 19,391 | 17,266 |
| WPD (South West) | 15,140 | 19,391 | 17,266 |
| Northern Electric | 15,003 | 18,870 | 16,937 |
| Seeboard | 15,293 | 18,263 | 16,778 |
| Yorkshire Electricity | 14,475 | 19,080 | 16,778 |
| Average | 15,563 | 19,508 | 17,536 |

'Max' Table

| Company | 1 April 2003 |
|---------------------------|--------------|
| | Max (£pa) |
| London Electricity | 21,242 |
| Manweb | 20,310 |
| Eastern Electricity | 19,907 |
| East Midlands Electricity | 19,614 |
| Southern Electric | 19,498 |
| Midlands Electricity | 19,458 |
| WPD (South Wales) | 19,391 |
| WPD (South West) | 19,391 |
| Yorkshire Electricity | 19,080 |
| Norweb | 19,074 |
| Northern Electric | 18,870 |
| Seeboard | 18,263 |
| Average | 19,508 |

* includes consolidation of £1,175 from Outer London Weighting.

** ** The 2001 rates have been updated inline with % pay increases year on year for each company to get to the April 2003 position