

Martin Crouch  
Director, Electricity Distribution  
Ofgem  
9 Millbank  
London SW1P 3GE

Your ref  
Our ref  
Name Mark Field  
Phone 01905 340 435  
Fax 01905 340 487  
E-Mail mark.field@npower.com

10<sup>th</sup> August 2007

## **DPCR5 – looking ahead**

Dear Mr. Crouch,

We welcome the opportunity to formally provide a response on behalf of the RWE npower supply businesses to your letter dated 17 May 2007 regarding our views on the next Price Control Review and associated processes, as currently scheduled for 2008. We confirm that we are interested and willing participants in this process and are more than happy to provide appropriate resources to aid the development of this area of work.

Further to the points raised in the open letter, with which we are generally in agreement, we have a number of additional points that we would like to make. These are outlined below and are intended to provide a supplier perspective in order to establish a balanced debate moving forward.

### **Structure of Price Control**

We do not perceive any problems with using RPI-X and believe that it is desirable for the industry to move towards the provision of longer Price Control Review periods but acknowledge that at present this is not possible or practical due to the inherent instabilities currently caused by the uncertainties around embedded generation, distributed generation, renewables and Smart Metering. At present therefore we feel that it is prudent to continue with the five-year review period.

### **Recovery Positions**

We have concerns over the current process regarding step changes in DNO tariff levels that occur as a consequence of their individual recovery positions and the Price Control Review process itself. These effects will almost certainly continue as DNOs currently review and update their Charging Methodologies with any associated rebalancing due, in the main, to be implemented early Q2 2008. Some degree of coordination between these activities would therefore seem to be desirable. It may be helpful if Ofgem were to quote a range of allowed revenue values within its review that caters for the difference between a pure price change resulting from the Price Control itself and an additional upper limit to allow for the DNO recovery positions, possibly taking into account the K values as provided by DNOs.

### **Transparency, Predictability and Accuracy**

In general, npower is looking for a Price Control Review that will establish appropriate levels of allowed revenue for DNOs but that will additionally provide an element of transparency, predictability and accuracy with regard to that revenue. We would ask that consideration is given to the further development of the under-pinning methodology that will attempt to remove the wider variations that

appear to have occurred during 2007, that has seen recovery positions for DNOs vary between £30m under recovery and £12m over recovery despite attempts to correct these trends on a couple of occasions. The volatility that these recovery positions cause leads to an off-setting of costs to Suppliers, higher operating costs and increased levels of uncertainty for all those involved.

**Use of Weighted Average Cost of Capital (WACC)**

In using the WACC model as part of the Price Control Review process we would ask that consideration is given to the cost of capital and rates of return calculations from a model essentially developed for a competitive market situation when applying this to monopoly businesses where inherent differences may generate certain distortions or over-estimates in model inputs/outputs. In setting P0 values we would prefer to see a process that allows for lower prices to be set initially with the ability to make a coordinated, mid-period change should one be required rather than incorporate a perceived uncertainty in the form of higher initial P0 values that may not prove appropriate over the whole review period. In practice this would result in lower P0 values with the potential of having higher X values to compensate for unforeseen price growth changes.

We anticipate that during subsequent stages of this process we will have the opportunity to better understand the reasoning behind some of the values used as input into the WACC model and to have the opportunity to be able to discuss their calculation and appropriateness in detail in order to further improve the model inputs and outputs. If this is not the case then it would be useful for us to know at this early stage.

We trust that the above is of assistance and should you wish to discuss our comments in more detail please do not hesitate to contact me on the above number.

Yours sincerely,

Mark Field  
Distribution Charging Manager