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value for all customers*

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Dear Colleagues,

Update on the DPCR5 process

Following the completion of the recent cost visits and the bilateral meetings, I am writing to provide an update on a number of key issues concerning DPCR5.

I am aware that many of you are now working on your main submissions for DPCR5. This letter contains a revised timetable for the remainder of the DPCR5 project, including a new deadline for your main forecast business plan questionnaire (FBPQ) submissions of February next year. I explain the role that output measures will play in the DPCR5 process and the additional requirements we will include in the FBPQ (Annex 1) which are driven by our focus on outputs and other matters. I hope that the extra weeks allowed for FBPQ submissions and early sight of what we will require, means that you will all be able to make full and well considered submissions in February.

I also set out our current thinking on the IQI mechanism. We expect to constrain the ability of DNOs to amend their February submissions and this again underlines the importance of DNOs doing all they can to make sure that their February submissions are accurate and have been internally tested.

In our bilateral discussions we explained our initial work on outturn Return on Equity during DPCR4 and how this provides a framework for the DPCR5 debate. In this letter I suggest a way forward for arriving at comparable ROE figures across all DNOs for publication in the December consultation document. I also set out our current thoughts on losses. I would appreciate your feedback on both of these matters within the timeframes set out below.

Role of output measures

Previous price control settlements have entailed DNOs having to deliver relatively little by way of formal outputs beyond the general requirement to meet licence and statutory requirements. Ofgem has incentivised certain types of outputs through specific mechanisms, such as interruptions and losses, but these do not encompass the full range of outcomes that result from DNOs' network investment and operational activities. As a result there may be some ambiguity regarding the nature of the overall price control settlement. Having thought further about this we propose that the price control settlement should allow DNOs to earn regulated revenues in exchange for them agreeing to deliver a defined set of outputs in a sustainable manner and meet all licence and statutory

requirements. This is in contrast to a settlement which involves the DNOs simply managing expenditure within their allowances or delivering a fixed volume of work such as a certain number of kilometres of overhead line and transformers replaced. We will seek to provide further clarification on the nature of the regulatory settlement in the December Policy document.

If we define the nature of the regulatory settlement in this way it follows that we need to work with you to agree output measures and associated targets for DPCR5 as an integral part of the price control process. It is practical in this review to define and measure these outputs on a company specific basis based on the systems and information that is available in each company, although in some areas such as CI and CML it will continue to be appropriate to have common metrics across the industry. Examples of possible output metrics include:

- Composite risk indices for highly loaded substations (customers at risk, time at risk, forecast demand growth etc.),
- Health indices such as the condition of transformers, switchgear and overhead lines,
- Modelled remaining useful life etc, and
- Fault rates.

For some limited areas of expenditure input measures may be more practical such as the number of substations where flood protection has been installed.

The impact this has on the FBPO submissions is set out in Annex 1. In particular, we expect companies to set out clearly the outputs that they will deliver relating to each of the building blocks as part of the main FBPO submissions in February. They will also need to show how these outputs would vary with changes in expenditure for each building block. We will make reference to these outputs as we assess the DNOs' forecasts and we will also seek to ensure that companies deliver value for money by including a set of outputs as a formal part of each DNO's regulatory settlement.

Companies that provide insufficient output information are likely to find it more difficult to convince us of their cost forecasts. For example, where there is insufficient output information we will place more emphasis on high level benchmarking or undertake a more detailed review of forecast expenditure and/or schemes. We are also considering whether, if a company is unable to provide an adequate range of measurable outputs, we should be seeking to constrain their ability to outperform against the WACC or to take other measures to reflect the greater scope that company will have to increase shareholder returns at the expense, for example of network condition. We are also considering different approaches we could take to monitoring compliance with the output measures and will consult on this issue in our December document.

Innovation and Future Networks

We understand that there is considerable uncertainty regarding the future of distribution networks and that it is unclear how and when factors such the roll out of smart meters, zero carbon homes and electric cars will impact on the way the networks are used. However, there is a growing consensus across many countries that distribution networks will have to become more technically sophisticated in the future. We are also aware that DNOs plan to replace a significant proportion of their assets over DPCR5 and this may provide an opportunity to make decisions that will help to future proof the distribution networks. With this in mind, as part of the FBPO we will ask DNOs to identify any low cost options which can be applied during this period of intensive investment which would make the networks more flexible to future changes, for example enabling the move towards smart grids through the DPCR5 period.

Distribution Losses

In the August FBPQ we allowed DNOs discretion on whether to include costs associated with lower loss transformers and/or over-sized cables (i.e. to reduce losses) in the main forecasts. During discussions at the bilateral meetings we discussed with some of you the potential of lower loss transformers and/or over-sized cables being allowed in the DPCR5 capex forecasts if the cost could be justified against loss benefits.

To explore this option further we are now providing additional guidance for the main FBPQs. Companies should provide their main forecast based on replacing equipment on a modern equivalent basis, appropriately sized for normal load growth, but not leading to significant changes in losses (known as the base case or business as usual). The FBPQ will now also include tables to capture additional expenditure that DNOs consider should be made over and above the base case to procure lower loss equipment, with a quantification of the expected loss reduction. It would be useful if a common methodology was used by all DNOs to estimate the expected loss reduction.

We also recognise the issues with the measurement of losses and the desire to identify technical losses explicitly. During the bilateral meetings WPD made a suggestion that could enable much better measurement of technical losses. They proposed that meters could be installed on the low voltage side of all secondary transformers (e.g. 11kV/LV). Used in combination with GSP metered data this would allow accurate measurement of technical losses for a very significant part of a distribution network – with the suggestion that this is the part of the network most amenable to loss reduction initiatives. Whilst residential smart meters would potentially also better facilitate the measurement of technical losses it will be some years before comprehensive roll-out is achieved and in addition smart meters will not measure theft where the meter is bypassed or damaged (which the secondary transformer meters would capture). WPD believed that these secondary transformer meters could be installed in under two years and at a reasonable cost.

I would welcome your opinions on this suggestion – especially whether you think it is feasible, how much it might cost and how long it might take to roll out smart meters at all secondary transformers. I am also keen to understand whether you think this would achieve an accurate measurement of technical losses and enable us to overcome one of the key obstacles we face in improving the losses incentive mechanism. Responses should be sent to Mark Cox (mark.cox@ofgem.gov.uk) by 19 November 2008.

High Impact Low Probability Events (HILP)

We understand that all or most DNOs have already had discussions with stakeholders on possible options for increasing the security of their networks in Central Business Districts to mitigate the impact of high impact low probability events. It is important for the February BPO submission that DNOs test the appetite of business customers in these areas to pay directly for the cost of this work rather than it being funded through the DNOs' entire customer base. DNOs should also compare this investment to other risks and costs on the network in considering appropriate levels of investment.

In the February FBPQ DNOs will also be able to provide forecast of other expenditure associated with HILP, not restricted to Central Business Districts.

Information Quality Incentive

We consider that the Information Quality Incentive (IQI) has been beneficial to customers both in DPCR4 and GDPCR and will continue to apply this mechanism as part of the DPCR5 process. However, there may be scope for further improvement in this approach, both in terms of the coverage and the effectiveness of the incentives. We are currently considering various submissions that have been made by the DNOs in this area and will set out further thoughts in the December policy document.

As part of the discussions on the IQI we have been considering whether it is appropriate to put some constraints on the ability of DNOs to update the FBPO forecasts later in the price control process. In considering this we would like to provide DNOs with sufficient flexibility to take into account valuable discussions throughout the process and changes in macroeconomic conditions while ensuring that the opportunity to update forecasts does not undermine the incentive the IQI mechanism gives DNOs to submit a true and well considered forecast in February.

We intend to adopt guidelines similar to Ofwat. After initial proposals, DNOs will be allowed to update their forecasts on the basis of new evidence or significant changes in outputs or scope of work but we will not allow wholesale changes to the forecasts. Companies will have to provide detailed explanations of changes to their forecasts.

This approach means that it is critical that DNOs do all they can to ensure that their February submissions reflect their best forecasts possible. It explains why we have extended the deadline for FBPO submissions and is one of the reasons we expect a shorter turnaround between initial and final proposals.

Return on Equity

An important feature of the price control arrangements is to mimic the incentives that apply to businesses in a competitive sector. Companies that perform well should earn an above average return on equity and companies that perform poorly should earn lower returns.

In the past there has been significant focus on the individual elements of the price control incentives such as performance against the cost forecasts, out-turn against the losses incentives or the quality of service incentives. While this is important, we are seeking to understand the effectiveness of the overall arrangements on a holistic basis and whether this is driving the right behaviour.

As such we have decided to publish DPCR4 return on equity figures on a consistent basis for all DNOs so that comparisons can be made and there can be a richer discussion of DPCR4 performance and areas for improvement of the incentives in DPCR5.

We will shortly be issuing an annex to this letter setting out our initial methodology for calculating return on equity figures for each DNO. We would welcome comments on this including your views on how these calculations should best be carried out. These should be provided to Kieran Donoghue (kieran.donoghue@ofgem.gov.uk) by 14 November 2008. We will then circulate our calculations to each of the DNOs by 21 November 2008 for comment by 28 November 2008. The final results will be included in the December policy document.

Updated timetable for DPCR5

An updated timetable for the remainder of DPCR5 is set out in Annex 2. Importantly it involves putting back the FBPO submissions to February of next year, and entails Ofgem publishing a new document in April/May next year ahead of initial proposals. This document will be narrowly focused and will set out the initial results from our cost assessment work. The purpose of this new document is to give DNOs and other parties a chance to comment on (and point out any errors or shortcomings in) the analysis we perform on the February submissions so that we can take these into account in our initial proposals.

We have shortened the consultation period for the December policy paper. This is to ensure that we have time to take into account responses on methodological issues ahead of the new cost assessment methodology and initial results paper in April/May. As we are

introducing an additional consultation paper we consider that this will improve the transparency of the process and effectiveness of the discussions.

We will provide a more detailed timetable in the December document, and ahead of that will be considering dates for the next round of meetings between the DNOs and the Authority. We are interested in getting feedback on the workability of the timetable for further RRP and FBPO submissions next summer, but plan to stand firm on all other elements of the revised timetable.

Please do not hesitate to contact me or Chris Watts on 0207-901-7333 if you have any queries or issues relating to this letter.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is placed over a light grey rectangular background.

Rachel Fletcher
Director, Distribution

Annex 1 - Additional requirements as part of the main FBPO submissions

The initial FBPO requirements for August 2008 were designed to give us an early understanding of the DNOs' forecast capex programmes and operating costs. We will need to gain a deeper understanding of forecast costs, associated outputs and variations to these as part of the February 2009 submissions:

- As discussed above we will be looking for comprehensive information on outputs, which are measurable, controllable and replicable over time,
- We will need to understand how these outputs vary with changes to the cost forecasts (through sensitivities or setting out the cost/output relationship),
- DNOs will need to explain how stakeholder engagement has informed their forecasts,
- We will need to understand the sensitivity of the cost forecasts to a range of other drivers such as labour prices, contractor prices, commodity prices, manufacturing lead times, changes in demand, smart metering etc,
- We will ask DNOs to estimate drivers for connections capex, general reinforcement and identify appropriate triggers for specific large schemes above a certain materiality. For example, general reinforcement may vary with group demand (MW) for a highly loaded substation,
- DNOs should identify the impact of a more cost reflective charging methodology on their investment forecasts, and
- We will request a more detailed explanation of the movements in actual customer contributions received and how future customer contributions have been forecast.

There are also a number of more detailed changes we are making including:

- Requesting information for each of the building blocks split by direct labour, contract labour, pension costs, materials, margins and other costs so we can better understand unit costs and also appropriately apply any regional or real price adjustments,
- Revising the approach to collecting connections information so that it ties up with the charging boundaries and contributions follow the costs that give rise to them,
- Splitting expenditure on quality of service improvements between indirect costs, direct opex and capex, and
- Capturing additional information on the incremental costs of investment in low loss equipment.

We have taken the need for this additional information into account in extending the deadline for submission of the main FBPO until February.

Annex 2 - Updated timetable for DPCR5

2008	
Early December	Publish policy paper Publish cost report Publish quality of service report
2009	
January	
February	DNOs submit detailed business plans (15 th February) Consultation closes for policy paper (15 th February)
March/April	Bilateral meetings between the Ofgem cost team and the DNOs
April	Publish methodology document/ initial results (April/May)
May	
June	DNOs submit reduced RRP information and FBPO update (26 th June)
July	Publish initial proposals (late July) DNOs submit full RRP data (late July)
August	
September	Publish updated analysis & allowances (if material changes from initial proposals)
October	
November	
December	Publish final proposals Publish draft licence modifications
2010	
January	
February	Publish statutory notice for licence modifications
March	
April	Beginning of new price control period