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Dear Mark,

GTC response to Ofgem consultations on:

Western Power Distribution proposal, UoS 12, to modify use of system charges to IDNOs; and

Consultation on an enduring common IDNO methodology to be implemented April 2010.

I provide this response for and on behalf of the Electricity Network Company, a wholly owned subsidiary of GTC.

This response is provided without prejudice to our legal rights.

Ofgem's consultation covers three areas:

- Western Power Distribution's proposal, UoS 12, to modify use of system charges to IDNOs;
- CE Electric UK's (CE) proposal for interim tariffs for IDNOs; and
- Reckon LLP's proposals for an enduring solution.

In summary:

- We support the WPD's proposal as an interim solution but we do not support a number of the principles on which it is founded.
- We do not support WPD's attempt to selectively exclude some costs from the methodology used to calculate tariffs for IDNOs; we believe this to be contrary to competition case law. Generally speaking, entrants are entitled to take the incumbent competitor as they find him.
- We support the use of an AAC approach in WPD's methodology.
- We do not support CE's proposed approach. Our initial analysis suggests that applying CE's proposed leads to negative margins for certain types of development (e.g. domestic developments with all electric heating). We believe that CE's analysis only considers sites on an unrestricted tariff. We have made the point on a number of occasions that margin squeeze can arise where there is an asymmetry between boundary and all the way tariff structures. This is why we advocate that a portfolio approach is required. Additionally, in order to comply with competition case law it is the notional downstream operating costs that need to be considered. We do not believe

that the total notional downstream costs are strongly correlated with the upstream capacity made available.

- It is unwise to judge the suitability of the proposed Reckon approach for an enduring solution until it is fully developed and IDNO tariff outcomes have been shared.
- We disagree with Reckon's view that the methodology should apply different annuity factors to IDNOs (as new entrants) than those that apply in respect of the DNO's own notional downstream business. Making assumptions about how another downstream operator may fund its capital expenditure is irrelevant. Competition case law makes it clear that it is the total costs of the incumbent's own notional downstream business that need to be considered in determining the available margins to new entrants.
- Asset replacement is not the only capital expenditure incurred by the notional downstream business. It must be recognised that the only mechanism available to IDNOs to cover all long term replacement costs (operational capex and non operational capex) is by the inclusion of provision in IDNO tariffs. Not all capital expenditure has a life of 40 years. In respect of asset replacement we disagree that this is a risk free activity for IDNOs.
- We favour the use of a portfolio approach rather than the use of banded tariffs. This is more consistent with the way that DNOs charge their own notional downstream businesses and is more likely to avoid margin squeeze issues arising as a consequence of different upstream and downstream structures.
- We believe banded tariffs give perverse investment signals and encourage duplication of networks. Nonetheless, we could accept a banded approach if Ofgem provides us with regulatory certainty that the price signals given will persist in the long run. Such certainty is required in order for us to invest in the networks we provide under such an approach.

The following principles apply generally to all methodologies:

- Actual costs rather than hypothetical forecast costs should be used wherever practical. Forecasts are inherently inaccurate and can be skewed to give different positions. We are uncertain whether the price control settlement is reflective of the costs incurred.
- If DNOs use the price control settlement to allocate costs then they should use the total costs for the price control period. This is because the costs within any given year of the price control will vary and may not be representative of long run costs.
- Ofgem comment that typically in the RRP DNOs attribute less than one third of operating costs directly to network components. This means two thirds of operating costs are indirect. The way indirect costs are allocated within a charging model will significantly impact the tariffs to IDNOs, irrespective of what the overarching methodology is.

General Points

We provide our detailed comments on WPD's consultation and the two discussion papers separately in the appendices to this letter. However, we also make some general points here.

We do not dwell on detailed analysis of competition law in this letter; however, the CNA presented its analysis of this in its presentation of the 1 December 2008.

Use of an Avoided Cost Approach

We have made the point on numerous occasions that using an avoided cost approach is erroneous. Competition case law consistently identifies issues in using such an approach. In assessing the avoided costs, many parties fail to identify the total costs avoided, and only identify the avoided variable costs, i.e. the avoided marginal costs. This is of particular significance in network businesses because a significant proportion of the costs incurred are fixed.

Use of DRM

We have previously raised concerns with the distribution reinforcement models (DRM) used by DNOs. This is because charges derived from the DRM fail to satisfy the requirements of competition law, i.e. the charges do not allow a notional downstream standalone business, which is at least as efficient as the DNOs downstream business, to recover its costs and make a profit. This is for a number of reasons. For example:

- The use of reinforcement costs skews the whole costs of operation towards the deeper, higher voltage assets. Typically, customers fund the provision of shallower assets through the payment of connection charges.
- The model does not properly account for replacement of assets.
- The use of scaling factors to match the outputs from a skewed reinforcement cost yardstick to the allowed income distorts the allocation of operating and customer costs.
- The asymmetry of the availability of DNO cost information means that we are unable to validate the way they allocate their costs.

We recognise that:

- the use of a DRM appears to be Ofgem's and the DNOs' preferred way forward for HV and LV end user charges and that DNOs, through the services of Reckon LLP, are developing a new DRM
- DNOs, again through using the services of Reckon LLP, are seeking to address some of issues we have raised. Whilst the DNOs, through Reckon, have made a copy of the model available for testing, we are unable to give a view on whether this new DRM produces charges that allow IDNOs to recover their efficient costs and make a normal profit in accordance with competition case law.

Use of banded tariffs (distance or capacity related) vs portfolio charging

We have always argued against the use of banded tariffs. This is because such an approach charges IDNOs differently from the way the DNO notionally charges its own downstream business. In charging their own notional downstream businesses, DNOs allocate average charges for different customer groups in their yardsticks. Using banded approaches focuses attention on the upstream costs for each network band. They fail to recognise that the costs of operating a given network and size does not vary with the connection to upstream network at different banding limits. Implementing a banded tariff based on network length creates a perverse incentive for IDNOs to connect nearer to DNO substations. This could result in duplicate sets of electricity cables being laid in public, each set being underutilised

We believe that DNOs should use a portfolio approach in setting charging structures to IDNOs. Portfolio tariff structures should replicate the tariff structures to end consumers. Nonetheless, despite our concerns, we could accept a banded approach (banded by length or capacity) if Ofgem provides regulatory certainty that we will be able to receive the appropriate margins from

each band over the longer term. Such certainty is required in order for us to invest in the extra lengths of network we provide under such an approach.

This is a detailed consultation covering many complex points and issues. To that end, we think there is some value in discussing our points in more detail with Ofgem. We will contact you in the next few days with a view to setting up a meeting for this purpose.

Yours sincerely

Mike Harding
Head of Regulation

Appendix 1

Detailed Comments to Western Power Distribution's proposal, UoS 12, to modify use of system charges to IDNOs

Ofgem's Decision to non-veto the current charging methodology

In their proposal, WPD refer to comments made by Ofgem in their decision document of 17/12/2007. In support of their decision to not-veto WPD's proposal (the methodology currently used by WPD to determine IDNO charges) Ofgem commented:

"Our results suggest that the proposed boundary tariffs would enable a licensed distributor at least as efficient as WPD to recover its costs and operate with a margin."

Following publication of their decision document, we asked Ofgem to explain to us how they arrived at this view. To date we have seen nothing to indicate that Ofgem undertook a proper analysis of what the efficient total costs of a notional downstream business are. We continue to hold the view that Ofgem's assertion and is flawed and does not stand up to scrutiny under competition law.

Response to Ofgem's Questions

Top down Vs Incremental

Whether WPD's proposal to use a top down AAC avoided cost approach is more cost reflective than their current DRM avoided cost approach?

We agree that WPD's proposal to use a top down AAC avoided cost approach is more cost reflective than their current avoided cost approach.

We have indicated in previous correspondence with Ofgem that the DRM approach (as currently applied by many DNOs) is fundamentally flawed. We are concerned that the methodology fails to allocate costs accurately in determining IDNO charges.

Whether WPD's proposal to use a top down AAC avoided cost approach does not restrict competition in distribution compared to their current methodology?

The proposal is an improvement on WPD's current methodology and is acceptable as an interim solution.

Whether it is appropriate and cost reflective to make a distinction between the methods used to calculate charges to IDNOs and end customers?

IDNO's have no ability to adapt usage to reflect price signals not end users! Methods could therefore be different.

The charges to end consumers do not change, irrespective of the approach adopted and irrespective of whether the consumer is connected to a DNO or IDNO network. Methodologies used to calculate charges to IDNOs are principally about determining how to allocate costs between the upstream and downstream operators. In providing last mile networks IDNOs substitute some of the activities that the DNO would otherwise provide.

In making any distinction between the methodologies used to calculate charges to IDNOs and end customers, it is appropriate to consider whether the methods used to calculate charges to end customers are cost reflective. Clearly, the view must be that they are not. Otherwise, Ofgem and DNOs would not be investing significant time and resources in developing new charging methodologies. Given that this is the case, why should IDNOs be subject to charges calculated using methodologies that do not correctly reflect or allocate costs?

If DNOs have to use different methods to determine charges in order to comply with competition law, it is appropriate that a distinction be made between IDNOs and end customers.

Whether it is appropriate to use the AAC method to provide a discount on the end customer charge derived from the incremental DRM?

We believe that this is a pragmatic approach for the interim solution. Looking to the enduring solution, we note that DNOs, through Reckon, are considering using a DRM approach as opposed to the AAC approach. Whether there is any significant differences between the AAC and DRM approaches (other than the use of terminology) remains to be seen.

Allocation of allowed revenue as basis for top down cost allocation

Is the approach of dissecting the price control settlement into operating costs, depreciation and return a suitable cost reflective approach?

There is an asymmetry between the cost information available to DNOs and that available to IDNOs and other parties. DNO's hold all the data; IDNO's do not have access to a full set. Whilst it is difficult to comment on whether the above approach (as applied) is suitably cost reflective, we make the following comments:

- Actual costs rather than hypothetical forecast costs should be used. Forecasts are inherently inaccurate and can be skewed to give different positions. We are uncertain whether the price control settlement is reflective of the costs incurred.
- If DNOs use the price control settlement to allocate costs then they should use the total costs for the price control period. This is because the costs within any given year of the price control will vary.
- Ofgem comment that typically in the RRP DNOs attribute less than one third of operating costs directly to network components. This means two thirds of operating costs are indirect. The way indirect costs are allocated within a charging model will significantly impact the tariffs to IDNOs, irrespective of what the overarching methodology is.

Is it appropriate to apply the cost allocation percentages derived from price control data, recent year RRP data and forward looking capex projections to ex post allowed revenues?

See response to question above.

We have no evidence one way or the other as to whether cost allocation percentages derived from price control data, recent year RRP data and forward looking capex projections to ex post allowed revenues, accurately represent the costs incurred and are consistent with data from the last 5 years.

DNOs will have different expenditure profiles for each year within a price control. Therefore it is the costs for the whole price control period that need to be considered

We are uncertain as to whether data contained within the RRP is of sufficient granularity to allow allocation of costs between upstream and downstream network activities.

Capital Costs

Do WPD's proposals to calculate the capital costs associated with their business and allocate them to network levels using FBPQ net capex better meet the relevant objectives? Is it appropriate to use the same allocation driver for depreciation and return?

We believe the WPD's proposal better meets the objectives when compared to their current methodology. Certain capital costs are fixed and not dependent on different network levels. We are uncertain as to how the significant fixed costs of the business are allocated

Is it appropriate to use FBPQ data which is based on forward looking capex estimates rather than actual, or historical capex spend?

We question the use of data from the FBPQ to allocate costs. This is because forecasts usually turn out to be wrong. As a general principle actual or historical data should be used. We understand that WPD are proposing to use FBPQ data because there is insufficient granularity in their historical data to allocate costs.

If FBPQ is to be used then reconciliation to historical data should be required. Also, in moving forward better granularity in historical can be achieved. Therefore, the use of forecast data should only be an interim step.

We are uncertain as to how the FBPQ treats non operational capex (e.g. IT systems, non operational buildings, vehicles), but this is an important category of IDNO costs that should be fully covered by the IDNO tariffs.

Does WPD's use of FBPQ net capex to apportion both depreciation and rate of return not restrict, prevent or distort competition compared to WPD's current methodology?

We believe the WPD's proposal better meets the objectives when compared to their current methodology.

Treatment of operating costs.

Do respondents agree with WPD's assessment that MEAV is the most appropriate (and cost reflective) cost driver to allocate those operating costs not split within RRP data? Please justify your answer.

DNO's have not shared any analysis of the impact of using MEAV versus other methods and so we do not know whether the use of MEAV is the most appropriate (and cost reflective) cost driver to allocate those operating costs not split within RRP data.

However, we do have some concerns in the use of MEAV as a cost driver.

Certain operating costs are fixed and not dependent on the value of assets (nor on network length). We are uncertain as to how whether using MEAV as a cost driver is an appropriate mechanism for allocating significant fixed operating costs. Comparing one DNO with another does not identify whether the use of an MEAV approach accurately allocates operating costs between upstream and downstream network activities.

We believe a significant proportion of indirect costs and overheads are customer driven and we have drawn attention to the allocation approach used in the gas sector where customer driven costs are a key element. To date DNO's have not compared the methodology results to inform the debate.

Do respondents consider that this method of identifying the operating costs associated with different network levels, better meets the relevant objectives?

We believe the WPD's proposal better meets the objectives when compared to their current methodology.

Treatment of pensions and incentive revenue

Is it appropriate for WPD to exclude pension deficit from allowed revenue before allocating it between network levels?

We believe that pension deficit costs attributable to the operation of the notional downstream should be included. In considering the allocation of costs to the downstream business it is the total costs that WPD incurs in operating its downstream business that should be considered, whatever their driver or history. Competition is intended to allow entrants to provide better services and lower costs which will be defeated by the anti competitive behaviour of WPD in selectively excluding certain costs.

Is it appropriate for WPD to exclude in year incentive income received/deducted from allowed revenue before allocating it between network levels?

Incentive income relates to the performance of DNO. To improve performance, a DNO will need to invest in systems, procedures and training. It is not unreasonable that DNOs should be able to recover the cost of that investment plus a return. Otherwise, there is no incentive and it is more cost effective for the DNO to operate at a lower level of performance.

We do not agree that incentives should be excluded in determining charges to IDNOs. In general, IDNOs will be expected to operate at a similar level of performance to DNOs. Therefore, where a DNO improves performance an IDNO will be expected to match or better the DNO performance.

Some incentives relate to the downstream activity (in whole or in part), whilst other incentives may only relate to the upstream business. For example, IDNO networks will have the effect of reducing DNO losses. This is because IDNOs are providing networks that the DNO would otherwise have to provide. The losses on an IDNO network are excluded from DNO loss calculations. So whilst DNOs benefit from the increase in distributed units to the downstream network they do not incur all of the losses. Such reduction in losses is solely due to the actions of the IDNO. Therefore the IDNO should share in the benefit directly.

Does WPD's proposal to exclude pension deficit and incentive income from allowed revenue better achieve the relevant objectives?

No, excluding important long run costs heads cannot lead to more cost reflective tariffs for notional downstream operators who also face all the same long term costs and funding challenges.

Basis of allocating LV and HV network costs between WPD and IDNOs

Is it more cost reflective for WPD to use the proportion of direct to indirect costs as a way of identifying the fixed and variable elements of the 'all the way' discount?

We believe the overall effect of WPD's proposal is that it is more cost reflective when compared to their current methodology; however, we have not seen any analysis to support the view that this approach is more cost reflective.

Does banding restrict, distort or prevent competition in Distribution? Is it more cost reflective for WPD to differentiate between HV and LV and propose bands solely at LV?

We support WPD's tariff proposal as an interim solution; however, we believe the WPD approach to banding has several serious drawbacks.

In allocating costs to its own notional downstream business WPD uses an average costs approach based on voltage of connection and the type of customer connected. We believe a similar approach should be used in respect of IDNO tariffs. The use of banded tariff approach to IDNOs results in IDNOs being treated differently from WPD's own notional downstream business.

Nonetheless, despite our concerns, we could accept a banded approach (banded by length or capacity) if Ofgem provides us with certainty that the price signals given by banded tariffs will persist in the long run. Such certainty is required in order for us to invest in the networks we provide under such an approach.

Does WPD's creation of IDNO specific tariffs for non domestic LV IDNO sites and IDNO specific tariffs at HV better achieve the relevant objectives?

We believe the WPD's proposal better meets the objectives when compared to their current methodology.

Is it cost reflective for WPD to distinguish between HV domestic and HV non domestic in the manner in which they calculate the respective tariffs?

We believe the WPD's proposal better meets the objectives when compared to their current methodology; however, we have not seen any analysis to support this approach.

Do WPD strike an appropriate balance between cost reflectivity and not restricting competition in their use of a domestic restrict tariff structure for all domestic IDNO tariffs?

We believe a portfolio approach to boundary charging is more cost reflective than site specific charges.

Nonetheless, we support WPD's proposal as an interim methodology and are of the view that WPD's proposal better meets the objectives when compared to their current methodology.

Impact analysis

Does WPD's proposal prevent, restrict or distort competition in distribution compared to their current IDNO charging methodology?

We believe the WPD's proposal better meets the objectives when compared to their current methodology.

Appendix 2

Detailed Comments to CE Electric UK's (CE) proposal for interim tariffs for IDNOs

What do respondents think of the CE approach and in particular its novel features such as optional capacity reservation facility and banding according to capacity.

We do not support the use of banded tariffs.

In our limited analysis to date we believe the proposed approach leads to negative margins for sites with off peak tariffs, i.e. the DNO gets more revenue from the IDNO than it would if it owned and operated the downstream network. This is the case for all banded tariffs. In calculating this we use a development comprising of electric heating with a total off peak consumption of 10 500kWh and an on peak consumption of 4407 kWh. (In respect of both NEDL and YEDL the night consumption has to be considerably lower for break even to occur).

CE indicates that their approach is to discount for avoided costs. In considering avoided costs it is the total long run avoided costs that need to be considered, not the costs avoided at the margin. The use of banded capacity creates a perverse incentive for the IDNO to request the maximum capacity within each band.

Competition case law suggests that the question that needs to be addressed is what additional costs does the IDNO bring to the operation of the LV network when it connects its network to an existing LV main (and reinforcement of the DNO network is required).

Case law makes it clear that it is the long run costs of the incumbents own notional downstream business that need to be considered in determining charges and that the revenues available should be sufficient for the DNO's own notional downstream business to operate the business and make a normal profit.

The tariffs suggested in CE's discussion document are single rate. ENC has a number of domestic developments which have all electric heating. This means that consumers will have a higher night time use and for which ENC will levy charges on a profile 2 tariff. We believe the tariffs should be two rate.

Capacity reservation

We do not support the CE proposal for capacity reservation, because it is not aligned to the approach CE use with developers directly.

The treatment reserving capacity for IDNOs should be consistent with the way developers have been treated.

When developers request a connection of a given capacity, the DNO provides the assets and makes the capacity available to the developer for a finite period after the development is energised - even though DNOs will point out that they have no specific agreement with the developer. In making that capacity available, the developer is not charged for use of system. What is open to debate is how long after the connection is the capacity (notionally) reserved – a day?, a year?, 3 years.

In contrast, when IDNOs connect to the DNO network they are charged in full (through the application of capacity charges at the boundary) for the capacity made available on connection to the DNO network.

It is with this background that many DNOs have established capacity ramping arrangements.

The correct approach is to ensure IDNOs are treated on an equitable basis, the same as developers. It was on this basis that capacity ramping proposals were introduced. If tariffs no longer have availability charge components the issue disappears to some extent since charges will only be levied in respect of kWh conveyed. Under the CE proposal the incentive is to ask for larger rather than smaller charges in order in order to secure lower DUoS unit rates.

If charges for reserving capacity are to be levied they should be levied through the connection charging statement and applied on the same basis to IDNOs as they are to developers.

Appendix 3

Detailed Comments to Reckon's proposal for an enduring solution for IDNO boundary tariffs

What do respondents think of the Reckon approach in general and its novel features such as the portfolio approach to tariff structure?

We support the portfolio approach to tariffs as being consistent with DNO all the way charges, which are based on regional averages.

Top down Vs Incremental

Is it more appropriate for an enduring solution to IDNO charging to be based on a 'top down' AAC allocation approach or a scaled incremental cost approach such as the one based on the DRM?

We prefer the use of a top down AAC allocation approach. As Ofgem identifies, we have a number of concerns with the use of the DRM. Irrespective of which method is used, we disagree that only the costs in a single year should be used. It is the total costs of the full price control period that should be used.

Previously, we have raised concerns about the use of the DRM to calculate tariffs to IDNOs. This is because, as currently applied, it leads to the allocation of costs being skewed towards the deeper assets. We are also concerned that the use of scaling further distorts the cost reflectivity. We recognise that Reckon have undertaken, and are continuing to undertake further work to address concerns we have raised. However, it remains to be demonstrated to us that the DRM is an appropriate methodology for determining IDNO charges

Does the answer to the above depend to any extent on the way that scaling is applied?

The way scaling is applied clearly impacts on the use of the DRM.

Ofgem comments that the use of fixed adder for end user charging is that by maintaining the absolute differential between HV and LV costs, it provides appropriate investment signals to end customers. We believe that in giving such pricing signals cost reflectivity is distorted.

If respondents consider that an AAC based approach is most appropriate, should this be based on an allowed revenue approach or an actual spend approach?

As Ofgem indicate in their consultation, the total revenues remain the same irrespective of whether Allowed Revenue or Actual Spend is used. The allocation of costs in an Allowed Revenue approach uses a forward-looking forecast. Forecasts are inherently inaccurate. On face value, using an actual spend approach would appear to be more appropriate. However, this is dependent on such an approach being able to identify and allocate actual spend to the relevant part of the network and to the relevant services provided. We understand that this is something WPD could not do in respect of their proposal and this is why they used a forward-looking forecast.

If respondents consider that a DRM based approach is most appropriate, does there need to be any adjustments to the current approach to reflect differences between end user tariffs and charges for embedded networks.

The DRM approach appears to only use replacement costs as a proxy for capital expenditure. We are uncertain how the DRM treats other non-operational capex which forms a significant part of downstream operator's costs which must be covered by the IDNO tariff. If it relies entirely on the scaling factors to address this then we have concerns.

Please set out any adaptations of any of the above approaches that should be reflected in the enduring solution, or propose which alternatives for the enduring solution you consider appropriate. Where alternatives are proposed, please specify the rationale for your preference.

The enduring solution should address the total costs of the notional downstream business and allow for a normal profit. We are uncertain as to whether the DRM does this.

We suggest that using only one year's worth of data increases the risk that costs may be unrepresentative of the long run and so it should be the whole data for the whole of the price control period that is used.

Capital Costs

Which method to estimate the proportion of revenues attributable to capital costs do you think is the most appropriate?

We believe the AAC approach is the most appropriate method and, as Ofgem note, more closely aligns with the requirements of competition law. We are uncertain whether the DRM is capable of delivering a methodology that produces IDNO tariffs that comply with competition case law.

We do not follow the logic of the argument put forward by Reckon. Competition case law makes it clear that it is the costs and risks of the incumbents own notional downstream business that need to be considered in determining charges. Therefore, making assumptions about how another downstream operator may fund its capital expenditure is irrelevant. Therefore, we reject the proposition that IDNOs should be afforded a lower annuity factor than the incumbent DNO.

Whilst it is true that IDNOs have younger assets and therefore do not have to immediately meet replacement costs, it is also true that IDNOs have other investment costs such as the significant investments required in IT systems. Such costs are relevant in the early years since IDNOs only have a small customer base; however IDNO's have no opportunity to fund replacement costs by adding expenditure to a RAV and then earning a return. The only mechanism available to IDNO's to cover long term replacement costs is by the inclusion of provision in IDNO tariffs.

Which method to allocate estimated capital costs do you think is the most appropriate?

Should the same allocation driver be used for depreciation and return?

The same allocation drivers that the DNO uses in respect of end user tariffs should be used.

Should DNOs be able to more directly attribute RAV costs to each network level on the basis of past capital expenditure and depreciation rates?

Yes, however, it is difficult to understand whether DNOs could accurately segregate the activities they undertake and the costs they incur between different voltage levels

Which method to allocate a return on capital do you think is the most appropriate?

WPD use a net capex approach as the allocation driver, which appears to give reasonable overall results, however, to inform the debate we would like to see Ofgem arrange a comparison of outcomes from the potential methods in order that a proper assessment can be used.

Operating costs

Which method do respondents think is the most appropriate for identifying Operating costs and why?

We do not believe the DRM is an appropriate mechanism for allocating costs for IDNO tariffs unless significant charges are introduced to ensure consistency to cost allocation approaches set out in competition case law.

Which methodology do respondents think is the most appropriate for allocating Operating costs to network levels and why?

Ofgem identifies that typically DNOs do not directly attribute more than two thirds of their operating costs. The decision on what cost drivers should be used to allocate indirect costs is very subjective. In selecting cost drivers a sense check is required in respect of the impact it has on the allocation. Therefore, it is likely to be an iterative process in selecting appropriate drivers.

Nonetheless, a significant proportion of these costs are fixed, i.e. they do not vary significantly by network length or by capital expenditure. Many of the upstream activities identified have to be provided by a downstream network operator.

Intuitively we feel:

- the use of a single cost driver where the costs between network levels are unknown seems inappropriate
- Activities such as Network Policy, Network Design and Engineering, Project Management, Engineering Management and Clerical Support are not driven by capex or the value of assets. We believe that customer numbers are more likely to drive such costs (at least in part).
- Items such as project management are not driven by capex. (For instance a primary substation plant will have a high capital costs but installing it will not require the same project management costs as laying a network of the same value).
- Using net capex skews allocation of costs because it ignores capital spend that is funded by the customer.

Allocation of LV and HV network costs between transformer and the point of connection

Do respondents consider that it is appropriate to reflect partial use made of the network level to which the IDNO connects in boundary charges? If yes, should boundary charges reflect site specific details or be set on an average basis? And if on a site specific basis what is the appropriate cost driver?

As explained on many occasions and captured by Ofgem in paragraph 2.70 of their consultation we do not consider that it is appropriate to reflect partial use.

Where a DNO has an existing network it recovers the costs of operating that network from existing end users. If an IDNO connects to that existing network (and there is no need for reinforcement requirement) the DNO incurs no significant additional long run costs. We would argue that the only costs that the DNO incurs are the copper losses and the costs of billing and managing the connection boundary to its network. However, in connecting to the DNO network the DNO receives the benefit of additional income from additional units being conveyed across its distribution network at all higher voltage tiers without any sharing of this benefit with IDNO's.

Do the WPD and CE approaches result in appropriate changes in boundary charges to reflect the costs of partial use of the network?

We believe the banded approach gives perverse investment signals, treats IDNOs differently from the DNOs own notional downstream business. Also, see comments to question above.

Which method of allocating LV & HV costs between DNO and IDNO do respondents consider is the most cost reflective?

Portfolio approach. It allocates costs on the same basis that the DNO would do if it owned and operated the downstream network.

Are there aspects of the different approaches which respondents consider could be used for the enduring IDNO charging methodology? Please justify your answer in terms of cost reflectivity and not restricting competition

We recognise that the methodology being developed by Reckon is still work in progress. As such it is unwise to try to reach a conclusion on whether the Reckon approach will deliver a suitable way forward. We recognise that the majority of DNOs appear to support the approach being developed by Reckon as forming the basis of an enduring solution.

The WPD AAC approach is a significant step forward from their current methodology. We are concerned that WPD use a subset of the total costs in determining costs (they exclude pension deficits, incentive payments). This is inconsistent with competition case law.

We favour the use of a portfolio approach. We are not convinced that the banding approach gives the right investment signals or that DNOs' additional costs of connecting to IDNO networks are correctly allocated.