ANNEX

Response to Consultation Paper's Questions

Chapter 2 – Overview of FBPQ forecasts

Question 1: What are your views on the DNO cost forecasts presented in this chapter?

WPD's forecast business plan for DPCR5 has not altered significantly between the August 2008 FBPQ and the February 2009 FBPQ submission.

We do not anticipate making significant changes in our final submission in June 2009 and outlined a number of small changes at the network investment bilateral meeting as follows:

- Updating 2008/09 figures from forecast to actual.
- Updating Real Price Effects (RPE) increases to reflect latest economic data.
- Updating expenditure on flood prevention to include latest site-specific survey information.
- Revising the QOS expenditure to take account of the 2008/09 network performance.

WPD is a high performing business and has a track record of delivering excellent customer service. Our forecast has been built up from robust, detailed plans and is supported by our stakeholders. WPD has the best track record of forecasting capital requirements and delivering to plan across the industry.

WPD need an early indication of support from Ofgem for its business plan in order to allow us to start to plan for delivery.

Chapter 3: Operational cost assessment methodology and results

Question 1: Have we exposed the correct costs to comparative benchmarking?

The following costs/activities should be excluded from the comparative benchmarking:

- Wayleaves
- Insurance
- Submarine cable
- Faults
- Remote location generation
- Unmetered electricity
- Low volume high cost faults

In respect of road charges (i.e. lane rentals, overstay fines and congestion charging), we propose that only congestion charging should be excluded from the comparative benchmarking. There appears to be some significant inconsistency across DNOs in respect of road charges. This inconsistency needs to be resolved.

We also agree that:

- IT & Property are assessed separately and independently.
- the pragmatic solution of allocating a portion of vehicles and small tools & equipment costs to network investment is appropriate.

However, the call centre activity should be separately identified and benchmarked as it is a relatively discrete activity. WPD's call centre is efficient and can demonstrate a high level of customer service performance compared to other DNOs and call centres outside the electricity industry in the UK.

It is not appropriate to include capex (the "totex" approach) in any of the cost comparative scenarios for the following reasons:

- Capex can vary significantly year-on-year and between regulatory periods.
- The long term nature of capex means that a very long timescale of capex spend should be investigated to make this approach acceptable – but in reality this is impractical.
- The definition of capex should be consistent, in particular:
  - capex directs information is only available consistently back to 2005/06.
  - capex should be subject to the same "normalisation" as all the other costs e.g. pension normalisation, one-offs, capex exclusions, etc.
- The distinction between load and non-load related capex is a boundary issue.
- Customer contributions policy and therefore income varies between DNOs.

Question 2: Do you agree with the assumptions we have made for our core analysis?

Related Party Margins

We agree related party margins should be included:

- Comparative analysis will drive out inefficiency where related party cost is high.
- Using the 75% rule per DPCR4 for disallowing margins is arbitrary.

Severe Weather Events

We agree severe weather events should be included, other than for very large 1 in 20 storms, where it is appropriate to add a separate allowance as in DPCR4.

Pensions

We agree pensions should be excluded because pension data is not available for contractor costs. In addition:

- Including pensions would encourage outsourcing and Ofgem should be cognisant of this point.
- Treatment of pensions separately ensures a more transparent process.

Regional Adjustment

We agree a regional adjustment should only apply to EDFE LPN in line with the GDPCR:

- Engineers and craftsmen operate in a national market.
- The Office of National Statistics (ONS) data used in the EDFE model is not the right level of disaggregation.
- The larger contractors are bidding for contracts in a national market.
- JIB rates covering 40,000 employees in the electrical contracting industry are national rates which only differ in London by 12%.

The EDFE apprentice starting salary is spurious:

- There is a distinction between “Adult” intake (over 18) and “Youth” intake (under 18).
- The Unite survey shows that EDFE’s intake for the last 2 years was “Adult“.
- WPD’s “Adult” craft trainees have a start salary of £19,399 very close to EDFE’s quoted £19,100.
- WPD’s apprentices are “Youth” intake (16) so therefore salaries are significantly lower.

Alliance Contracting

The proposed adjustment for Alliance Contracting is not valid. To illustrate this point it is worth comparing WPD and EDFE.

WPD does not engage in either Alliance Contracting or use contractors to deliver turnkey projects. Consequently, WPD report all the indirect activity costs associated with the delivery of capital works as indirect activity costs in the RRP. The relevant indirect activity costs are Engineering Management & Clerical Support, Network Design & Engineering and Project Management.

In contrast EDFE engage in Alliance Contracting and use contractors to deliver turnkey projects. In Ofgem's May 2009 Initial Results paper, it is explained that EDFE have "open book" contracts whereby contractors' indirect activity costs on turnkey projects are identified and are now shown as indirect activity costs in the RRP. It is entirely correct that EDFE should report contractors' indirect activity costs as indirect activity costs in the RRP. This "open book" approach ensures that in the RRP, EDFE are reporting indirect activity costs on a basis that is consistent with WPD and other DNOs.

Ofgem's proposed Alliance Contracting adjustment whereby contractors' indirect activity costs are re-assigned from indirect activity costs to direct capital expenditure results in EDFE's indirect activity costs to be stated on a basis that is no longer consistent with WPD and other DNOs. The proposed adjustment is inequitable as it favours EDFE, by materially understating their indirect activity costs, but penalises DNOs who manage the delivery of capital projects using in-house staff.

Therefore, the proposed £15.2m adjustment to EDFE's indirect activity cost base should not be undertaken. However, in order to ensure that EDFE are not treated inequitably, Ofgem should ask DNOs who engage contractors to undertake turnkey projects to identify the value of contractors' indirect activity costs that are embedded in the direct activity costs. For such DNOs, the values can then be used to reduce direct activity costs and increase indirect activity costs. This will ensure that all DNOs are treated equitably and consistently.

The use of external contractors can mean that the indirect costs in the contract price are not separately identified, in which case a DNO would classify the indirect cost element as "contractors" in direct costs mainly as direct capex.

Urbanity/Sparsity Adjustments

The selection of the correct cost driver makes the need for such adjustments superfluous.

The cost drivers proposed in Table 2.4 now reflect that assets drive costs not customers (Composite Scale Variable (CSV)).

The need for assets in the urban (greater transformer capacity) or rural context (extensive overhead line network) is taken into account e.g.

- Asset hours work driver varies with asset size/number
- MEAV driver varies with asset size/number

Question 3: What are the appropriate cost drivers for each of the cost groupings?

There are some primary or secondary cost drivers in Table 3.1 that are incorrect as follows:

- Indirects Group 1 – Network Investment £m
- Indirects Group 2 – Total Direct Costs £m
- Indirects Group 3 – DPCR4 CSV

Indirect costs are essentially driven by the total tasks that are required to be undertaken on the network.

Any measure of total tasks undertaken on the network must be objective and should not be reliant on short term fluctuations in value, and should be auditable. Any short run measure of total tasks undertaken on the network would be an unreliable indicator of the requirements of Engineering Support Activities because:

- Operational capital expenditure can vary significantly from one year to the next so too crude.
- In the period 2005/06 to 2007/08 capex increased by 29% without any increase in indirect costs – therefore, indirect costs are immune to significant changes in direct capex.
- Asset age profiles can influence capital expenditure requirements.

The best measures of total tasks undertaken on the network are those that consider the long run task by using the whole asset base. Such measures of network scale are:

- Task Generated by Asset Base
- Modern Equivalent Asset Value (MEAV)

Whilst “Task Generated by Asset Base” is probably the best driver there is some subjectivity in determining it. Therefore we consider that MEAV is the most appropriate driver of all the three indirect groupings.

The CSV should not be used as a cost driver because costs are not driven by either customers or load but are driven by assets.

Question 4: How should we determine baselines for the costs excluded from comparative benchmarking?

Our proposals are as follows:

- Wayleaves: take 2008/09 actual (2007/08 for Initial Proposals) and then factor in an appropriate increase thereafter to take into account revised national wayleave agreement.
- Insurance: base on 2008/09 actual (2007/2008 for Initial Proposals), because insurance has increased in real terms over the last few years, and neutralise any captive insurance profit or loss.

- Low volume high cost faults: base on average of last four years.
- Submarine cable: base on longer timescale, say average of last ten years.
- Remote location generation: base on average of last four years adjusted for new mainland links to National Grid.
- Unmetered electricity: base on average of last four years.
- Congestion charging: base on average number of payments made during last four years and most recent level of charge.

Question 5: How should we treat atypical costs in the price control settlement?

Atypical costs should be excluded in principle from cost comparisons provided that they are defined on a consistent basis for all DNOs.

The following items should be excluded:

- Very severe 1 in 20 storms.
- Credits/rebates (e.g. insurance rebate) for items with significant value (suggest greater than £2m) for costs not incurred in the period 2005/06 to 2008/09 (the period for analysis).

Other costs should be questioned (such as data clean-up) before being abstracted, because it is important that costs are excluded on a consistent basis.

Where costs recur each year then they cannot be treated as atypical without further explanation and justification.

Question 6: What weight should we give to the benchmarking relative to other considerations?

The benchmarking should be used to set allowances with allowed costs levels being at the base level, as they were in DPCR4.

The benchmarking work is considerably more robust than in previous reviews:

- RRP defined data has been collected since 2004/05.
- Consistency in data is considerably better than at DPCR4.
- Considerable resource has been employed by Ofgem and DNOs to derive cost drivers.
- Ofgem's team is much more conversant with costs and particularly what is important.

Chapter 4 – Methodology – Core network investment

Question 1: Do you agree with Ofgem's approach to assessing core network investment allowances based on the wide range of evidence details in the chapter?

We agree with Ofgem's generic three step approach to the assessment of core network investment allowances. In addition, we agree that it is appropriate to undertake this three step assessment separately for each of the "building blocks".

However, it is evident that step one of the assessment, i.e. initial modelling, is not sufficiently robust, particularly in respect of asset replacement. We will expand on this later.

As part of our FBPQ submissions we provided Ofgem with an extensive commentary and extensive supporting information. We are very disappointed that Ofgem have made no use of the information that we provided prior to the initial modelling; and have in fact asked us, as part of step two of the assessment process (i.e. DNO feedback), to resubmit much of the information and data that we had already provided.

It is appropriate for Ofgem to consider wider evidence in step three of the process. Ofgem are aware that in October 2006, WPD became the first DNO to achieve accreditation of their asset management system to PAS 55 (2004). However, Ofgem will be interested to know that WPD have just become the first DNO to achieve accreditation to PAS 55 (2008). These accreditations were granted following extensive audits undertaken by an independent body, i.e. Lloyd's Register, who identified many aspects of WPD's asset management process as best practice.

The latest Lloyds Register executive report states that "it is very important that WPD, at all levels within the business, are focussed on ensuring continuing excellent customer service through efficient use of their assets. In addition it was very clear that there is widespread commitment to keep databases correctly populated so that asset condition is thoroughly monitored."

Question 2: Do you agree with the primary network general reinforcement modelling methodology that Ofgem has adopted for DPCR5?

In general we agree with the primary network general reinforcement modelling methodology adopted for DPCR5.

There are some areas for further consideration on (Extra High Voltage) EHV/132kV Reinforcement;

- Due to the relatively small number of schemes within this analysis group, expensive schemes (e.g. 132kV cable reinforcement) can lead to distortion within the analysis.
- Load Growth in the last two years of DPCR5 period is ignored. We are concerned this implies that non-compliance with P2/6 is seen as acceptable for two years before any reinforcement is deemed necessary by Ofgem.

- Where load transfers off a substation/group are planned and built into the load forecast, these will produce an artificially low calculation of load growth.

Question 3: Do you agree with the asset replacement modelling methodology that Ofgem has adopted for DPCR5?

The initial asset replacement modelling that has been undertaken by Ofgem is incorrect.

We have identified two flaws in Ofgem's asset replacement modelling.

Input Data

It has been identified that there has been significant differences in the way that DNOs have populated FBPQ Table NL3. This is particularly evident in respect of overhead lines. We are aware that some DNOs have omitted replacement quantities, particularly overhead line poles, from FBPQ Table NL3.

This has resulted in inconsistent data being entered into Ofgem's model. Ofgem have asked DNOs to comment on asset types where the DNO's forecast activity volume materially exceeds Ofgem's forecast activity volume. Ofgem should also ask DNOs to comment on asset types where the DNO's forecast activity volume is materially lower than Ofgem's forecast activity volume as this will begin to reveal omissions from Table NL3. The omission of data by some DNOs is having detrimental impact on those DNOs, such as WPD, who have provided full forecast activity volume data.

Use of Output Replacement Volumes

We understand, from data provided on 14th May 2009 that for each asset type, Ofgem's model aggregates the forecast replacement quantities for the seven year period 2008/09 to 2014/15. Ofgem then determine that the forecast activity level for the DPCR5 period to be $^{5}/_{7}$ of the seven year total for each asset type.

The approach is different to that used in Ofgem's May Initial Results Document. This is an invalid calculation because asset replacement volumes are forecast to increase through the DPCR5 period. Therefore, taking $^{5}/_{7}$ as the activity level for DPCR5 understates replacement requirements.

Question 4: Is the outlined process for developing Initial Proposals suitable?

The process outlined for the development of initial proposals does not take into account all of the required steps, in particular:

- Ofgem should ask DNOs to comment on asset types where the DNO's forecast activity volume is materially lower than Ofgem's forecast activity volume as this will begin to reveal omissions from Table NL3;
- Correct the one year time slip flaw that has been introduced into Ofgem's asset replacement survivor model;
- Rerun the initial results model using a full data set and corrected model; and.

- Correctly determine the asset replacement quantities for DPCR5.

It is only after the rerunning of the model that meaningful discussions regarding differences in forecast asset replacement quantities can be investigated.

Chapter 5 – Network investment - Environment

Question 1: Do you agree with our approach to assessing the forecasts of distributed generation, discretionary expenditure and losses and are there any other factors you think we need to take into consideration?

Distributed Generation

There is much uncertainty around the forecasting of Distributed Generation (DG) and the levels of connection in DPCR4 did not meet expectation. Our DPCR5 forecast for DG capacity to be connected has been informed by Local Government targets & aspirations to meet such targets, hence they may also be aspirational but with high levels of uncertainty. WPD do have DG capacity with 'accepted offers' and although progress on actual connections is slow these accepted offers are starting to bring the networks towards full capacity for DG and we would therefore expect to see some levels of increase in reinforcement works associated with DG (not seen to date), although we still believe at a relatively low level.

Discretionary Expenditure

Secondary Substation Metering
We welcome the opportunity to discuss the benefits and costs of this project with Ofgem and have recently hosted a number of successful meetings to discuss our detailed proposals with Ofgem, Ministers, MPs and DECC.

Losses (low loss equipment)

We will discuss our justifications with Ofgem as requested.

Whilst our payback periods are shown to be highest at 15yrs, it is evident from comparison of the factory price data in DNOs FBPQ submissions that other DNOs have built low loss equipment into their base case. Our information indicates that there is a very wide range of DNO base case factory pricing for both pole and ground mounted distribution transformers, and that WPD's base case for pole mounted units is the lowest and for ground mounted units very nearly the lowest and half that of the highest. Consequently we believe that the current analysis is flawed - it needs to take into account the iron and copper losses on each rating of pole and ground mounted units, with the corresponding factory delivered costs.

Chapter 6 – Ongoing efficiencies and input prices

Question 1: Have we identified the most relevant unit cost and productivity measures from other sectors to help inform our ongoing efficiency assumption for DPCR5?

The metrics that Ofgem has included in table 6.1 of its consultation document are, in principle, good measures of the rate of productivity improvement and the rate of change in unit cost in an industry.

First Economics has previously identified an error in the way that Ofgem's GDPCR consultants allowed for changes in the capital stock over time. Ofgem will need to revisit and take on First Economics' points prior to making its July 2009 initial determination.

Question 2: When calculating these measures, which comparator sectors and time periods should we focus on?

The majority of the sectors included in table 6.1 should be capable of giving insights into the scope for the DNOs to improve productivity and reduce costs.

However, two of the industries chosen – manufacture of electrical/optical equipment and manufacture of chemicals – are not natural comparators and should be omitted from the data set. In the case of electrical/optical equipment, the data reveals productivity trends in the upstream markets that DNOs purchase from. Annual productivity growth will be reflected in the rate of change in the price that DNOs pay for materials like transformers and cable and should not be double-counted in an efficiency assumption applied separately to DNO expenditures. In the case of chemicals it is not at all clear what it is that makes this sector a relevant comparator to the DNOs.

Ofgem should also switch the relatively narrow financial intermediation comparator with the wider finance, insurance, real estate and business services. This would permit Ofgem to take in evidence of productivity improvements achieved by providers of accounting, recruitment and IT providers, which are more relevant comparators for DNO indirect costs.

As far as time periods are concerned, Ofgem should focus on data from the 1990 to 2005 rather than the longer 1970 to 2005 period. It is not at all clear why evidence of productivity growth in the 1970s and 1980s is relevant to costs in the period 2010 to 2015.

Question 3: What weight should we give to this analysis relative to other information?

DNOs have a right to expect Ofgem to consider all of the information put before it during the course of a review and not just the analysis that it has commissioned itself. On this basis, the First Economics work and the DNOs' own analysis merit at least equal weight to the analysis summarised in Chapter 6 of Ofgem's document.

Ofgem should also consider how consistent its position is with the determinations made by other regulators, recognising in particular that most recent periodic reviews have incorporated an at, or slightly-above, RPI trend in opex, and a significantly above RPI rate of increase in capital unit costs.

Question 4: What method should we use for setting our input price assumptions for DPCR5?

As per the response to Q3, all of the evidence compiled during the course of the review should be given equal consideration.

Whichever methodology is used it is important that the period considered is 2009/10 to 2014/15 and not 2010/11 to 2014/15 as implied by Ofgem's document.

Chapter 7 - Customers

Question 1: Do you agree with the proposed mechanism (in full) for worst-served customers?

We agree with the proposals for the operation of a worst-served customer incentive as set out in Table 7.1.

The proposed total allowance of £42m is less than the amount proposed for undergrounding schemes in Areas of Outstanding Natural Beauty (AONB) as set out in Appendix 6 in the December 2008 policy paper. We think this balance is wrong and that expenditure that delivers real improvements in service to customers should have a higher priority than expenditure on visual amenity.

It is not appropriate to make the allowance for the scheme ex-post. There is a danger that DNOs will not participate in the initiative as the uncertainty of being able to meet the qualifying conditions together with no guarantee of recovering investment in DPCR6 introduces additional risk and may act as a disincentive.

Question 2: Do you agree with the proposed approach (in full) for setting unplanned targets for customer interruptions and customer minutes lost?

Although we agree with the proposed approach for setting unplanned targets for customer interruptions and customer minutes lost, we have serious concerns with Ofgem's stated intention not to provide any up front cost allowances for improvements in performance which far exceed benchmark performance.

Capex Allowances
The incentive rates set out in the document will not drive the capital investment necessary to improve CI performance.

Example WPD South Wales

- Reduce CI by 1 (assume consequential impact on CML of 0.5).
- Capital investment required £5.8 million in years 1-2.
- Annual interest charges on £5.8 million £0.4m (assume 7% pre tax).
- IIS Reward £0.39m total (years 3-5 based on £0.07m per CI pa (Table 7.7), £0.12m per CML pa (Table 7.8).

The reward is not enough to meet the interest charges on the investment.

Opex Allowances
At DPCR4, DNOs who accepted a target that is tougher than the 2020 benchmark received an additional allowance. This allowance recognised:

- The additional weather related volatility risk under IIS of exceptionally demanding targets.
- The additional operating costs that less efficient operators would incur to meet similar standards.

There are three DNOs (WPD South West, WPD South Wales and SSE Hydro) whose CML performance is *materially* better than the 2020 benchmark. It is inconsistent and inequitable not to recognise this efficiency.

How the May unplanned CML 2014-15 targets have been chosen

DNO	DPCR4 average	2014-15 benchmark	Performance as a % benchmark
CN West	89.7	79.7	113%
CN East	65.5	58.9	111%
ENW	48.7	47.7	102%
CE NEDL	58.2	55.4	105%
CE YEDL	68.0	60.6	112%
WPD S Wales	39.9	59.6	67%
WPD S West	43.2	58.2	74%
EDFE LPN	39.1	38.5	102%
EDFE SPN	83.8	59.1	142%
EDFE EPN	62.4	55.0	114%
SP Distribution	66.1	50.6	131%
SP Manweb	53.9	49.7	108%
SSE Hydro	58.6	74.8	78%
SSE Southern	64.8	58.4	111%

Source: Ofgem Electricity Distribution Price Control Review. Methodology & Initial Results Paper. Appendices, Appendix 10 Table 5

Question 3: Do you think that we should set a cap on the cost per benefiting customers within the worst-served customer mechanism and, if so, what level should this be set at?

The setting of an appropriate cap per benefiting customer will be difficult without experience of what can be achieved within the proposed worst-served customer mechanism. Setting the cap at an inappropriate level may result in very poorly-served customers being excluded from the scheme.

Provided DNOs meet the other requirements set out in Table 7.1 then there should be no need to set a cap per benefiting customer.

Chapter 8 – Network output measures

Question 1: Is Ofgem's proposed methodology for general reinforcement and asset replacement outputs appropriate?

It is appropriate to develop a set of suitable network output measures. The network output measures to be developed should focus on general reinforcement and asset replacement.

The categorisation of output measures into three tiers is useful. However, the tier two output measures that are proposed are not measures of risk – they are measures of "probability of failure".

We agree with the principles of Ofgem's proposals in respect of the:

- Proposed common methodology for 132 kV & EHV reinforcement investment and asset replacement investment;
- Use of tier two output measures for 132 kV and EHV reinforcement investment and asset replacement investment;
- Qualities of tier two outputs measures, such as measurable, controllable, auditable and replicable over time, as described in paragraph 8.14;
- Use of a "one to five" banding for both Load Indices and Health Indices.

Question 2: Is Ofgem's proposed approach for other areas of investment appropriate?

On Page 115 of the methodology and initial results paper, Ofgem have identified that the areas of investment not covered by outputs (existing or proposed) and incentives (existing or proposed) are:

- LR3 - Diversions,
- LR4 - LV and HV general reinforcement,
- LR6 - Fault Level,
- NL8 - Operational IT and telecoms, and
- NL9 - Legal and Safety.

In Appendix 11, Ofgem have also included Building Block NL7 – Major System Risks within the scope of "other areas of investment". We agree with the scope of "other areas of investments" as identified in Appendix 11.

We agree that for "other areas of investment" it would be appropriate for Ofgem to monitor tier three outputs during DPCR5 without holding the DNOs to formal output measures as part of the settlement. We do not agree that it should be a Licence Condition requirement for DNOs to develop tier two output measures during DPCR5. If valid tier two output measures cannot be identified for any of the "other areas of investment", then the DNOs would be in breach of their licence. It is more appropriate to seek commitment from the DNOs to work with Ofgem to develop relevant output measures.

Use of Output Measures During DPCR5

We agree with Ofgem that the proposed tier two output measures are not suitable for benchmarking and that during DPCR5, the output measures should be used to assess a DNO's performance over time.

We agree that it would be appropriate to monitor the tier two output measures on an annual basis. However, as these are new output measures, we do not have experience in respect of the year-on-year volatility of the output measures. We anticipate that there could be a time delay between occurrence of investment and change in output measure, particularly in respect of fault rates. Experience of how the output measures change year-on-year can be gained during DPCR5.

We will work with Ofgem during DPCR5 in order to refine the output measures so that inter-DNO benchmarking can be undertaken in future reviews.

Question 3: What approach should be taken if a DNO fails to deliver the agreed outputs, ie how could the incentives be adjusted?

The detailed regulatory framework will need to provide some flexibility for DNOs to reprioritise their target output measures. The need to reprioritise target output measures would arise, for example, if:

- Load growth was materially different to the planning assumptions underpinning the DPCR5 settlement;
- The deterioration rate of an asset was greater than originally forecast; and
- A type-specific defect on a range of switchgear brought forward a material amount of asset replacement.

In such circumstances the DNO would be able to demonstrate the change in output measures as a consequence of the change in circumstances. In such cases, DNOs should not be penalised for not achieving the original target output measures. One way of providing the necessary flexibility would be to aggregate up target site or asset-specific type output measures into logical groups. For example, the target output measure included in the licence could be for all switchgear or all HV switchgear. This would give the DNO the flexibility to reprioritise investment plans in light of changing circumstances.

Question 4: Do you consider that the output measures proposed provide sufficient protection in their own right, or is it appropriate to have some form of additional safety net in the DPCR5 settlement, for example through monitoring investment volumes?

Provided the approach outlined in Question 3 is adopted there would be no need for any additional monitoring of investment volumes.

Question 5: Should there be an obligation on DNOs to further develop output measures during DPCR5?

We agree that DNOs should commit to a package of output measures as part of the DPCR5 settlement.

We support Ofgem's process for refining the proposed common methodology, the publication of output measures in the Initial Proposals and the iterative process to finalise network investment allowances and level of output measures.

We do not agree that it should be a licence condition requirement for DNOs to develop output measures during DPCR5. Given the early stage of development of output measures, it is more appropriate to seek commitment from the DNOs to work with Ofgem to develop relevant output measures.

Question 6: We seek views from stakeholders on the role that outputs should play in DPCR5 and particularly how they can best be implemented and used.

See above.

Chapter 9 - Cost incentives

Question 1: Do you agree with our proposed approach to equalise incentives?

We agree adding a common percentage of all costs other than business support costs into RAV will reduce the incentive for a DNO to classify costs to enable a higher proportion fall into RAV.

However, we have some concern that mixing opex and capex will no longer drive down costs traditionally classified as opex. This is because opex costs are more predictable than capex costs which are prone to the timing and size of capital projects. The management perception that any opex efficiency could be offset by an overspend on capex will dilute the incentive to make real cost efficiencies.

Question 2: Have we identified the most appropriate costs to be within the equalised incentive and the IQI?

Yes

Question 3: How should we set the "RAV additions percentage" that will determine the split between "slow" and "fast" money?

Ofgem should initially ensure that allocations line up with the total allocation in DPCR4 to opex and capex, and then test that the financial indicators produced ensure a DNO credit rating of A-/A3, that is comfortably within investment grade.

Chapter 10 – Managing uncertainty

Question 1: What balance should we adopt between mechanisms to manage specific risks (such as input price uncertainty) and a more general type of re-opener to manage a wider basket of risks?

We agree that there should be a mechanism to manage the specific risk in investment levels required to fund new connections and possibly general reinforcement, but believe that other risks should be managed by a more general type of reopener with a trigger mechanism which only comes into play if a DNO can demonstrate that costs have risen significantly above the assumptions made for DPCR5.

Whilst we recognise that customers or shareholders should not unduly gain or lose from variances in key input price assumptions, we consider that it is impractical to implement an input price index. A significant proportion of costs relate to staffing which in practice track RPI and so are automatically hedged.

Question 2: What risks should be covered by specific mitigation mechanism, by a general type of re-opener, and which should be left to the DNOs to manage?

See above.

Question 3: Are there any additional risk mitigation mechanism that we should be considering that are not identified in this chapter?

None that we can identify.

Chapter 11 – Tax methodology

Question 1: Is the approach to modelling DNOs capital allowances on a common basis representative of the industry position and does it ensure that no individual DNO is materially advantaged or disadvantaged by this methodology?

The DPCR4 methodology for allocating expenditure to tax pools worked to the detriment of the DNOs in that it assumed that tax relief would be given earlier. Ofgem have recognised this and are trying to move closer to the DNOs' real positions. Although a common basis may represent the industry as a whole, it does not take into account differing patterns of expenditure, tax treatment of overheads and historic agreements with HMRC which may result in a DNO being materially advantaged or disadvantaged. It is important to recognise that as the tax liability is calculated on expenditure split on a statutory accounts basis, the model should allocate the expenditure on a similar basis, otherwise the same issue will arise in DPCR5 as did with DPCR4.

As Ofgem have recognised the allocation of overheads is sufficiently different between DNOs to warrant specific treatment, the same principle if applied to the allocation of costs between capital allowance pools would go some way to achieving Ofgem's aim of modelling tax on a basis close to their actual cash tax liability. This information is available as a result of the detailed work done in allocating the tax treatment to the detailed expenditure as set out on Table 8 of the financial FBPQ tables.

It must also be recognised that it is the individual DNO capital/revenue expenditure profiles that drive their tax allocations and not the tax allocations of the other DNOs, and as the allocation of expenditure to the various tax pools is determined by legislation, there is limited opportunity for a DNO to 'manage' its tax position.

In addition, if Ofgem are proposing to use the closing tax pool balances as reported in the tax returns to determine the opening position for DPCR5, any changes made by Ofgem to that reported position would affect the cash tax liability.

Question 2: Views are invited on whether the most appropriate option for the tax treatment of re-openers is the case-by-case approach.

This is the most appropriate option for the tax treatment of re-openers.

Question 3: Should the DNOs retain the risk and rewards for all amounts below/above the trigger threshold; or for the entire amount rather than the excess over the materiality trigger; and what should be the appropriate timing of adjusting DUoS revenues following both single and multiple trigger events?

Provided the trigger materiality threshold is set at a reasonable level, then any adjustment should be for the excess, as this would provide consistency for instances where a trigger does not reach the threshold.

Ofgem are specifically excluding changes in, or clarifications to, HMRC interpretation of legislation or new precedents set under case law on the basis of complexity, not measurable, etc. However it must be recognised that the change to the tax treatment of

capitalised revenue expenditure was as a result of this. It would therefore be important to include these categories in the definition of legislative changes so that Ofgem achieve their aim of mitigating the risk and upside of changes that are outside the DNO's control.

It is difficult to predict the period of notice that will be given to changes in the tax regime. If the trigger is activated by changes to the rate of corporation tax or capital allowances, it is unlikely that that these will occur more than once in a price control period. Iit would make sense to deal with these on a case-by-case basis. Other changes are also unpredictable and again should be dealt with in the same way.

Question 4: We invite views on the practicality of communicating the likelihood of a trigger being activated and the methodology for it.

Changes to the corporation tax rate and capital allowance regime will be announced in the budget or autumn statement, so that would be the prompt to re-run the DPCR5 financial model to calculate whether the trigger would be activated. The results would then be agreed on an individual DNO basis. Any other changes would likely be identified by the DNOs rather than Ofgem (due to their more specialist nature) and should be communicated as soon as practicable.

Appendix 12 – RAV application issues

Question 1: Views are invited on the approach to RAV additions and the range of costs to be capitalised.

On balance, we support the totex approach, provided that the cost allocations line up with the total allocation in DPCR4 to opex and capex, and the financial indicators produced ensure a DNO credit rating of A-/A3 that is comfortably within investment grade.

Question 2: Views are invited on which approach to these costs is equitable over the long term as between DNOs and consumers and should be adopted?

Provided that the cost allocations to RAV are in line with DPCR4 this should be an equitable solution for DNOs and consumers.

Question 3 (para 1.9): Views are invited on whether there should be a separate treatment of normal pension costs and/or deficit repair pension costs and on how and if they should flow into RAV.

There is no reason to change the current arrangements and the DPCR4 treatment of pension costs should be maintained in DPCR5.

Appendix 17 – Excluded services

Excluded services fall into two categories.

Category 1 comprises services costed via use of system charging methodologies;

- Reactive power charges
- Top up and standby charges
- New EHV customers

Whilst these charges are set at a cost-reflective level it is not possible to separately identify the costs within company systems and the only assumption that can be made is that the cost matches the charge.

Category 2 comprises;

- Special metering
- Revenue protection services
- Cost of providing statements (de minimis)
- Rechargable diversions

These are areas where it would be possible to identify the costs. Of these items, only rechargeable diversions are significant and are effectively regulated, as it would be discrimination to charge above a level of the cost that these activities are undertaken within our business.

Considering the 3 new options presented,

Option 2 – use of all DNO average – the market for certain services is geographic in nature e.g. new EHV customers. This means that the use of an average would not be an incentive but a bonus or penalty depending on the DNO.

Option 3 – partial true up – a symmetrical partial true up would provide some smoothing of changes and hence would be more appropriate for the excluded services calculated as part of use of system charges compared to the other excluded services.

Option 4 – 'cost plus' control for excluded services – we do not know how this option would work for services calculated via use of system charges as the direct costs involved cannot be identified.

This leaves Option 1 – status quo – despite its downsides; this still appears to be the best option of those considered.