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Dear Rachel,

Electricity Distribution Price Control Review -Methodology and Initial Results Paper

Wales & West Utilities Ltd ("WWU") welcomes the opportunity to comment on this paper. We have targeted this response to those areas where we consider our view will assist in the development of the process. We have referenced our responses to the relevant chapter and question number in the consultation.

For the avoidance of doubt our response is not confidential, and can be published.

Chapter 3: Operational cost assessment methodology and results

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

Whilst benchmarking is an important tool, it needs to be used appropriately and treated with caution. In comparing entities it is important to ensure sufficient account is taken of factors specific to individual DNOs which would mean that they are naturally more or less costly than the benchmark. These factors could include sparcity, network length, network age, network resilience etc relative to the other DNOs. In setting allowances comparative benchmarking is just one approach to determining an efficient level of spend and therefore other approaches should also be taken into consideration, such as historic performance and an assessment of the future level of efficiency that can be applied against this performance.

WWU consider it inappropriate to include the costs for "Network Policy, HR, Finance & Regulation, CEO etc" in the regression analysis. A base level of "back office" resources is required to deliver the licensed activities of a network. If the licence owner operates more than one network there will only be a marginal increase required in these resources to support additional networks compared with those to support the first network. A multiple network owner should have a lower average cost per network than a single network owner. Consequently regression analysis of these costs alone will not deliver an equitable assessment of the relative efficient cost of each network ownership group. A better approach would be to allow a base allowance for the first network owned and add the incremental cost per additional network owned to reflect multiple network ownership.

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The economy of scale from multiple network ownership would be passed onto the consumer in setting the allowances.

An example of difficulty in ensuring appropriate benchmarking is pensions. Ofgem has excluded pension costs from direct labour costs in their comparative benchmarking (see paragraph 3.26). It is important that Ofgem ensure where an alternative labour source is available, such as contractors, that the pension cost is also removed from that source, otherwise the benchmarking would compare a direct labour cost excluding pensions with an outsourced solution including pension costs.

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

We note that the analysis is not complete and will provide additional comment when this area is developed further.

We would welcome clarity from Ofgem on why severe weather atypical events remain included in core allowances when other atypical events are excluded.

Rather than a Singleton Adjustment, we consider a better approach to deal with a single ownership structure is a base allowance awarded for the first network owned with the incremental cost associated with multiple network ownership being given for subsequent networks in a multiple network group.

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

We note that the majority of these costs are IT & Property. Allowances for these items should be set using a range of techniques including (i) the use independent experts, who are fully conversant with the issues involved and who have current knowledge of the market, industry and outputs, and (ii) through using the results of the DNO / Ofgem RRP sessions to understand efficient levels of spend.

Chapter 9: Cost incentives

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

We are unable to comment in detail on Ofgem’s proposal to equalise incentives without fully understanding the entire proposed regulatory framework. Incentives are one part of the risk and reward structure within which regulated entities operate, and without being aware of the entire framework (including proposed WACC) it is not possible to quantify if the overall risk/reward balance has altered.

We believe one reason for the differentiation in the incentive treatment of opex and capex spend is because (i) opex is relatively easier to benchmark (but note our concerns above) and, absent atypical events, tends to result in consistent levels of spend each year (ii) capex over a price control period is significantly more uncertain as it is influenced by external forces such as consumer demand, is more difficult to benchmark due to the unique nature of a high proportion of the underlying projects and is not incurred evenly over a price control period. A benefit of the IQI mechanism on capex is to enable risk sharing between consumers and the regulated entity of the impact of this uncertainty on the risk faced by the regulated businesses. Such a risk sharing has not previously been considered necessary for the opex spend.

It is generally accepted that the current strong incentive on operating costs has benefited consumers since privatisation. Consequently, Ofgem should fully consider the impact on the DNOs of including opex under/out performance within the IQI mechanism. The reduced strength of the incentive may limit the ability of consumers to benefit from efficiency incentives that require DNO investment.

We believe that changes in the incentives should only be made if they are expected to result in benefit to consumers whilst appropriately rewarding the regulated entities. It is also important that DNOs are incentivised to undertake cost reduction initiatives, the benefit of which is passed onto the consumer on a timely basis; this can be achieved through the introduction of an opex roller mechanism.

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

We understand that Ofgem are trying to address the existing boundary issues surrounding network costs and their allocation between opex and capex. Whilst we do not have detailed knowledge of the treatment of this expenditure and therefore some of the issues within the electricity industry, the approach adopted in gas regulation to determine the appropriate treatment of expenditure appears to work well. We therefore believe that UK generally accepted accounting definitions of opex and capex, together with standard interpretations of these definitions, will ensure a high level of consistency in treatment between regulated entities in gas.

In relation to paragraph 9.35, WWU agree with the exclusion from the IQI mechanism of costs which have a high degree of uncertainty, TMA, High Impact ~ Low Probability etc, as these items have the potential to significantly affect the result of the IQI mechanism whilst not being readily predictable by the DNOs.

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 reopener to manage a wider basket of risks?

WWU agree that, due to the uncertainty over the real increase in materials prices over time, a specific adjustment should be built into the control to allow for this real price change based on a widely available reported index.

WWU also consider that similar adjustments should be incorporated for the real price increase in contract labour costs.

WWU consider the introduction of a mechanism such as IDOK (where the impact of pre-identified items with an impact greater than 10% of annual regulated revenue can be adjusted during a price control) used in water regulation to be advantageous. The key is the definition of areas which would be included within the scope of IDOK.

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

See response to question 1 above.

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

See response to question 1 above.

<u>Chapter 11: Tax methodology</u>

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?

Where there are changes in the tax burden outside of the DNOs control these should be fully recovered through the price control even if these are below the trigger.

Yours sincerely,

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