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value for all customers*

Direct Dial: 020 7901 7209

Email: dpcr5.reply@ofgem.gov.uk

Date: 21 September 2009

Dear Colleagues,

September Update to Initial Proposals

1.1. We published our Initial Proposals in early August 2009, in which we outlined our view of the maximum revenues each DNO should be allowed to collect from customers between 2010 and 2015. In these proposals we highlighted several areas of costs where we were still to receive the information we needed from the DNOs and other parties to form a view on the appropriate baseline revenue allowance. We committed to providing our updated view on these areas of costs in September. This letter and associated appendices provides the promised update. To clarify, this update only covers those areas of work that were incomplete at Initial Proposals and is not a full update of our analysis. The updated figures in this letter do not take account of any responses to our Initial Proposals or make amendments to our analysis.

1.2. This letter provides an overview of the analysis we have carried out and our proposed baseline allowances and/or treatment of costs in the following areas:

- Core network investment: demand connections expenditure.
- Non-core network investment: High Impact Low Probability (HILP) events, flooding, BT 21st Century (BT21CN) expenditure, Rising and Lateral Mains (RLM), black start capability and emergency batteries, Critical National Infrastructure (CNI), losses and discretionary expenditure.
- Network investment policy: the Traffic Management Act (TMA), Transmission Exit Charges (TEC) and the reopener for load-related expenditure.
- Financial issues: recovery of bad debts incurred in DPCR4.

Overall effect on total network investment

1.3. Our updated proposals are summarised in Table 1 below. The overall effect of the update is to reduce the allowances we set out in Initial Proposals by £315m, or 2.4 per cent. We estimate this will bring the anticipated average annual increase in distribution use of system charges down from 5.3 per cent to 5.0 per cent over the DPCR5 period. All DNOs face a reduction from their Initial Proposals allowance with the exception of WPD S Wales and CE YEDL whose allowances have increased due to a revised assessment of flooding expenditure. The largest reduction is to the proposed allowance of EDFE EPN.

1.4. In Initial Proposals we used the DNOs' forecasts as our modelling assumption for many of the costs which are the subject of this update. There are three reasons that this update has reduced the revenue allowances in Initial Proposals. Firstly, our analysis suggests that DNOs could undertake some of the activities in this update at a lower cost than they have forecast, and the upfront allowance we propose to give

to the DNOs has been reduced accordingly. Secondly, in some areas of activity, such as replacement of rising and lateral mains, there is still considerable uncertainty over the scale of costs that the DNOs will face. In these cases we do not consider it is appropriate to set an upfront allowance or to fund activities fully through an upfront allowance. Instead we propose to fund the activities later in the price control period through a reopener, logging-up or a hybrid mechanism if it proves necessary. These appear as negative adjustments to Initial Proposals. Finally, the DNOs have updated their FBPQs since the publication of Initial Proposals, which may affect our baseline view presented at Initial Proposals.

Table 1 – September Update changes to Initial Proposals

Total Network Investment expenditure - September Update proposals													
DNO £m (07/08 prices)	Initial Proposals	Adjustments driven by assessment of costs						Adjustments driven by treatment of costs (reopener/logging up etc.)					Total
		Customer specific demand connections	BT21CN	Flooding	Losses	Discretionary	Total adjustments	HILP	RLM	Black start & emergency batteries	CNI	Total Adjustments	
CN_West	575.6	-5.0	-2.3	0.4	0.0	0.0	-6.9	-5.7	0.0	-0.5	-2.4	-8.6	560.1
CN_East	578.7	-3.8	-7.0	1.5	0.0	0.0	-9.3	0.0	0.0	-0.5	-2.4	-3.0	566.5
ENW	506.9	-28.3	0.0	1.6	0.0	0.0	-26.8	-2.8	0.0	0.0	0.0	-2.8	477.3
CE_NEDL	355.5	-9.0	0.0	-0.7	0.0	0.0	-9.7	0.0	-2.4	0.0	0.0	-2.4	343.4
CE_YEDL	443.8	-14.4	0.0	22.1	0.0	0.0	7.6	0.0	-3.5	0.0	0.0	-3.5	447.9
WPD_S_Wales	198.6	0.0	0.0	2.6	0.0	0.0	2.6	0.0	0.0	-2.0	0.0	-2.0	199.2
WPD_S_West	302.6	-0.1	0.0	0.2	0.0	0.0	0.1	0.0	0.0	-1.4	0.0	-1.4	301.3
EDFE_LPN	495.2	0.0	0.0	0.7	0.0	0.0	0.7	-50.8	-0.5	-6.6	0.0	-57.9	438.0
EDFE_SPN	494.3	-5.8	-7.1	0.3	0.0	0.0	-12.5	0.0	-1.0	-9.0	0.0	-10.0	471.7
EDFE_EPN	623.7	-12.0	-15.4	0.9	0.0	0.0	-26.5	0.0	-0.5	-21.0	0.0	-21.5	575.7
SP_Distribution	405.9	0.2	-4.0	0.0	2.1	0.0	-1.6	-1.0	-26.2	-0.5	-5.0	-32.7	371.6
SP_Manweb	553.8	0.4	-17.3	4.9	2.1	0.0	-9.8	-1.6	-14.3	-1.0	-6.0	-22.9	521.1
SSE_Hydro	210.4	-0.5	0.0	-1.1	0.0	0.0	-1.6	0.0	-0.9	-6.0	0.0	-6.9	201.9
SSE_Southern	591.5	-1.9	0.0	-4.3	0.0	0.0	-6.2	0.0	-3.0	-8.0	0.0	-11.0	574.3
Total	6336.6	-80.4	-53.1	29.2	4.2	0.0	-100.0	-61.9	-52.2	-56.6	-15.8	-186.5	6050.1

Sept update - TMA costs ex ante allowance			
DNO £m (07/08 prices)	Initial proposals TMA	September Update proposals TMA	Change from IP to SU
CN_West	4.0	3.9	-0.1
CN_East	4.3	3.5	-0.8
ENW	7.6	7.6	0.0
CE_NEDL	1.0	1.0	0.0
CE_YEDL	1.6	2.0	0.4
WPD_S_Wales	1.7	1.4	-0.3
WPD_S_West	2.5	2.7	0.2
EDFE_LPN	14.6	10.6	-4.0
EDFE_SPN	11.2	4.1	-7.0
EDFE_EPN	21.9	8.5	-13.5
SP_Distribution	5.0	5.1	0.1
SP_Manweb	4.8	5.1	0.3
SSE_Hydro	0.9	1.0	0.1
SSE_Southern	6.5	2.3	-4.1
Total	87.5	58.8	-28.7

Use of reopeners, logging up and hybrid mechanisms

1.5. We are proposing to have reopeners and logging up for a number of categories of expenditure considered within this letter. In some cases, such as low-cost high-volume connections, this is because there are volume uncertainties outside the control of the DNOs and we consider it appropriate to protect DNOs on the upside

and customers on the downside. In other cases, such as costs associated with the permitting schemes under the Traffic Management Act, we do not have sufficient information to set an ex-ante allowance and will be relying on a reopener/logging up mechanism to set the allowance once the relevant information has been revealed.

1.6. Table 1 shows the areas of cost which are funded through ex-ante allowances (highlighted blue) and those that are being dealt with through reopeners and logging up (highlighted red). In addition to these areas, and as explained in our Initial Proposals document, we are proposing a reopener for load related expenditure associated with general reinforcement and the shared element of high-cost low-volume connections that is DUoS funded.

1.7. We are aware of the risks of introducing such mechanisms. These include: unpredictable volatility in charges for customers and suppliers because allowed revenues may change within the price control period; the resource requirements of reopeners; and the potential weakening of efficiency incentives. To address these risks we are considering a number of options: smoothing adjustments from reopeners over a number of years, setting materiality thresholds to trigger reopeners, grouping reopeners where appropriate, and application windows for reopeners to reduce their frequency. In considering these options when setting final proposals we will need to balance their benefits against ensuring that our approach does not expose DNOs to significant costs that would not be financed within the DPCR5 price control period. We would welcome views of stakeholders on the introduction of more of these mechanisms and the options to address their risks.

Network investment cost assessment

1.8. Our updated proposals for network investment allowances are detailed in Appendix 1. A summary is provided below.

1.9. In Initial Proposals we recognised that the data gathered for **customer specific demand connections** in the June FBPQs needed further review. There were significant differences between DNOs' unit costs that needed further explanation. We have now gathered more information regarding the DNOs' forecasts and carried out analysis to reach our September Update view. In the appendix we present our baseline allowance for demand connections and our proposal for three volume drivers for low cost high volume connections, representing different segments of the connections market. These drivers will be based on volume, unit costs and the actual level of connections paid for by the connecting customer (according to the apportionment rules). This will correct allowed revenues for changes in the proportion of connection costs that are recovered upfront from customers.

1.10. In Initial Proposals we highlighted several areas of non-core network investment where we were unable to present baseline allowances due to the uncertainty of the costs and/or reliance on input from third parties to determine requirements for investment.

1.11. Required expenditure on **black start and emergency batteries** will be determined by the recommendations of the Electricity Task Group to the Energy Emergency Executive Committee (E3C). This is due to be finalised in spring 2010. Expenditure on **CNI** will depend on requirements determined by The Centre for Protection of National Infrastructure (CPNI), who are currently reviewing physical

security provisions at key DNO sites. We propose that efficiently incurred costs in both these areas are logged up during DPCR5. For CNI costs the logging up mechanism will apply to 95 per cent of incurred costs to encourage efficiency in this area.

1.12. Five DNOs have forecast expenditure on **High Impact Low Probability (HILP)** risks, with 82 per cent of the total relating to EDFE's proposals for London. DECC and Ofgem have examined further EDFE's HILP proposals for London. We propose to facilitate meetings between the DNOs, DECC and key stakeholders to further explore the extent to which customers are willing to pay for increased security. If the issues relating to funding of HILP remain unresolved we propose that these costs are logged up with black start and CNI costs subject to a materiality threshold. Beyond this the DNOs will be eligible to apply for a reopener.

1.13. Our initial proposals did not include any adjustment to expenditure forecast for **rising and lateral mains**. Having further assessed the DNOs' submissions and the range of issues presented we propose to include an ex-ante allowance to provide interim funding for these costs for two years, after which allowances will be reassessed through a reopener. The period of interim funding will allow time to resolve ownership disputes and investigate potential issues. Although we are providing some ex ante funding for the first two years we will, at the next price control review and/or as part of the reopener, seek evidence from the DNOs that they have established ownership and sought to recover the costs from customers where appropriate. Where the costs have been recovered directly from customers or where DNOs have not used all reasonable endeavours to establish ownership we may claw back some (or all) of these allowances.

1.14. Since Initial Proposals BT has provided an update regarding its plans for **BT21CN**, giving more certainty as to the range of services that will be provided and the related costs through to 2018. In light of this information the DNOs have provided an updated high level forecast of expenditure. Based on these forecasts we now propose an ex-ante allowance. The baseline proposal will be updated for final proposals pending the review of more detailed scheme-by-scheme information.

1.15. DNOs have continued to refine their **flood expenditure** forecasts for DPCR5 as the results from site surveys and information from the Environment Agency/Scottish Environment Protection Agency have become available. In addition to changed data, we have now incorporated into our analysis the forecast change in risk levels from the DNOs' programmes as well as factoring in the number of critical customers in addition to general customer numbers. The allowance will be updated for Final Proposals if DNOs provide further site specific survey information.

1.16. We stated in Initial Proposals that we would work with the DNOs to finalise proposed expenditures to reduce **technical losses** by September. This exercise has resulted in the addition of £4.2m to the £11.4m already identified in Initial Proposals.

1.17. In Initial Proposals we stated that we had not received sufficient justification for us to assess schemes submitted as **discretionary expenditure**, and stated that if we received detailed and thorough proposals and justifications by September we would consider including the proposed expenditures. One DNO, WPD, submitted a detailed justification for their proposed £54.5m to install smart meters on low voltage substations. We are currently working with WPD to see whether the proposal could be more focussed using a targeted trial.

Network investment policy

1.18. In Initial Proposals we proposed to include a **reopener associated with general reinforcement and high-cost low-volume connections**. The reopener could be triggered where DNOs could demonstrate a net 20 per cent greater efficient expenditure on connections and general reinforcement than the Ofgem baseline. It could also be triggered by Ofgem at the end of DPCR5 if we determine that efficient expenditure is 20 per cent less than our assumption due to a change in demand and/or fewer high-cost connections. Appendix 2 provides further detail of the evidence that we would require if the load related reopener is triggered.

1.19. Since initial proposals we have developed a greater understanding of potential requirements for permitting under the **Traffic Management Act (TMA)**. However, there still remains uncertainty over the timing and level of permit fees. In Appendix 2 we propose an ex-ante allowance for traffic management excluding any permitting costs. We propose to assess additional costs arising from the introduction of permitting schemes as part of a reopener during DPCR5 (where DNOs put forward an application) or at DPCR6.

1.20. Since Initial Proposals we have analysed the DNO forecasts of **transmission exit charges** and have assessed the accompanying justifications and compared this against information supplied by NGET. This has given rise to a number of inconsistencies that we are currently unable to resolve. As such there needs to be further joint work by the industry and Ofgem to reach a position where there is more consistent information on which we can set an ex-ante allowance for Final Proposals.

Financial issues

1.21. The DNOs have reported that they have incurred approximately £6m in **bad debts** during the DPCR4 period to date. We have asked each of the DNOs to confirm that the costs incurred comply with our established best practice guidelines. Based on this information we will propose relevant adjustments to DNOs' allowed revenue figures for 2010-11 in Final Proposals. We currently expect to say that any bad debts expensed or specifically provided for after publication of Final Proposals need to be logged up by DNOs for consideration at DPCR6. Details are provided in Appendix 3.

Responses

1.22. The attached appendices provide further detail of our analysis and proposals. Within the appendices we raise questions seeking views on our proposals. We would welcome responses by 19th October 2009, sent to Rachel Fletcher, Partner, Distribution, DPCR5.reply@ofgem.gov.uk. Please do not hesitate to contact me if you have any queries or issues relating to this letter.

Yours sincerely,



Rachel Fletcher
Partner, Distribution

Appendix 1 - Network cost assessment appendix

Question 1: Do you consider the volume drivers proposed for customer demand connections to be appropriate?

Question 2: Do you consider the proposed reopener for low volume, high cost connections and general reinforcement appropriate? Is it set at the right level?

Question 3: Do you agree with the proposed mechanisms (reopeners/logging-up) for dealing with uncertain costs?

Question 4: Do you agree with our proposed methodology for setting flooding expenditure allowances for DPCR5?

Customer specific demand connections

1.1. In the Initial Proposals document we provided details of the DNOs' forecasts for demand connections. We did not make any adjustment to these but signalled that we would update our proposals in the Autumn taking account of:

- current and forecast economic conditions,
- results of benchmarking average cost per connection for connections subject to the volume driver,
- scheme specific reviews of large connection schemes, and
- analysis of the percentage of gross connection assets funded by the DNO due to the apportionment rule.

1.2. We have now undertaken a review of the DNOs' proposed expenditure based on the information provided as part of the June FBPQ submissions. Table 2 below shows our updated proposals for demand connections.

Table 2 - Demand connections

Demand Connections									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	56.1	26.2	-53%	20.8	-5.4	-21%	-5.0	-35.4	-63%
CN_East	89.4	66.6	-25%	62.3	-4.3	-7%	-3.8	-27.1	-30%
ENW	72.9	24.4	-67%	8.8	-15.6	-64%	-28.3	-64.1	-88%
CE_NEDL	11.0	20.0	82%	11.0	-9.0	-45%	-9.0	0.0	0%
CE_YEDL	9.8	28.6	192%	14.2	-14.4	-50%	-14.4	4.4	45%
WPD_S_Wales	6.0	5.4	-10%	5.4	0.0	0%	0.0	-0.6	-10%
WPD_S_West	10.7	7.8	-27%	7.7	-0.1	-1%	-0.1	-3.0	-28%
EDFE_LPN	3.4	11.0	224%	10.5	-0.5	-5%	0.0	7.1	209%
EDFE_SPN	22.3	48.8	119%	42.3	-6.5	-13%	-5.8	20.0	90%
EDFE_EPN	25.4	29.1	15%	16.8	-12.3	-42%	-12.0	-8.6	-34%
SP_Distribution	22.0	16.4	-25%	16.4	0.0	0%	0.2	-5.6	-25%
SP_Manweb	36.0	40.5	13%	40.5	0.0	0%	0.4	4.5	12%
SSE_Hydro	16.5	16.7	1%	16.2	-0.5	-3%	-0.5	-0.3	-2%
SSE_Southern	24.7	58.8	138%	56.9	-1.9	-3%	-1.9	32.2	130%
Total	406.2	400.3	-1%	329.8	-70.6	-18%	-80.4	-76.4	-19%

1.3. Demand connections expenditure can be split into two categories:

- expenditure on sole use connection assets which are directly funded by the connecting customer, and

- expenditure on connection assets which could be used by a number of customers. These are subject to the apportionment rule and are only partly funded by the connecting customer. These are known as "shared assets".

1.4. As discussed in Initial Proposals, expenditure on sole use connections assets that are directly funded by the connecting customer will be treated as an excluded service during DPCR5. DNOs will be allowed to earn a margin on the direct costs associated with contestable elements of the connections work and, subject to passing a competition test, may then charge an unregulated margin on these services. Only net expenditure relating to shared asset connections is recoverable through the price control.

1.5. Ofgem's proposed baseline is a composite of an ex-ante allowance for larger (low-volume high-cost) connections and an ex-ante baseline which will flex up or down for smaller (high-volume low-cost) connections, depending on the volume of actual connections made.

1.6. The volume driver will be applied to 'small scale LV domestic and one-off commercial connections', 'all other LV connections with only LV work' and 'LV end connections involving HV work'. The driver will be based on our assumption for gross unit costs. For the DPCR5 baselines we have applied the lower of the DNO's net to gross ratio or the industry upper quartile net to gross ratio. This will be trued up at the end of DPCR5 based on their actual net to gross ratio. All other connection types will be funded through a fixed ex-ante allowance. Note that these volumes only refer to connections where there are connection assets subject to the apportionment rule and therefore do not include the volume of sole use connections. The table only includes the shared element of expenditure that is funded through DUoS charges.

1.7. As LV end connections that do not involve HV work are relatively homogeneous within their respective category, we consider that the use of an industry median as the maximum unit cost is appropriate. We have therefore used the minimum of either the industry median¹ or the DNO's forecast average gross unit cost for 'small scale LV domestic and one-off commercial connections' and 'all other LV connections with only LV work'.

1.8. LV end connections involving HV work undertaken by DNOs are usually more heterogeneous than connections that solely involve LV work. As such we consider the use of a maximum unit cost based on the upper quartile of the industry's average unit cost is more appropriate for this type of connection. The gross unit cost allowed for 'LV end connections involving HV work' is the minimum of either the industry unit cost upper quartile or the DNO's forecast average unit cost. The volumes are as forecast by the DNOs.

1.9. Ofgem's unit costs and volumes to be used in the volume drivers are given in Table 3 below.

¹ The median for 'small scale LV domestic and one-off commercial connections' was calculated excluding the gross unit costs for SP and SSE. We consider these unit costs to be outliers and are still waiting for further information from SP. The median unit cost for 'all other LV connections with only LV work' excluded ENW from the calculation as this was over five times higher than the next highest. Analysis is still being undertaken on ENW's relatively high unit costs.

Table 3 - HVLC connection unit costs

DNO	Small scale LV domestic and one-off commercial					All other LV connections (with only LV work)					LV end connections involving HV work				
	Volume	Gross unit cost £	Gross baseline £m	Net as a proportion of gross	DPCR5 baseline £m	Volume	Gross unit cost £	Gross baseline £m	Net as a proportion of gross	DPCR5 baseline £m	Volume	Gross unit cost £	Gross baseline £m	Net as a proportion of gross	DPCR5 baseline £m
CN West	838	6,741	5.6	52%	2.9	1314	1,587	2.1	19%	0.4	2745	5,058	13.9	35%	4.9
CN East	951	6,741	6.4	34%	2.2	3608	1,723	6.2	18%	1.1	7749	4,065	31.5	42%	13.1
ENW	486	4,148	2.0	52%	1.0	903	1,723	1.6	33%	0.5	452	5,058	2.3	44%	1.0
CE NEDL	313	6,741	2.1	9%	0.2	4708	1,723	8.1	40%	3.2	1510	3,383	5.1	44%	2.3
CE YEDL	648	6,711	4.3	10%	0.4	7826	1,723	13.5	35%	4.7	2645	3,017	8.0	44%	3.5
WPD S Wales	0	0	0.0	--	0.0	627	1,723	1.1	17%	0.2	3372	2,728	9.2	24%	2.2
WPD S West	0	0	0.0	--	0.0	683	878	0.6	49%	0.3	4900	1,837	9.0	22%	2.0
EDFE LPN	0	0	0.0	--	0.0	820	1,723	1.4	25%	0.4	738	5,058	3.7	44%	1.6
EDFE SPN	0	0	0.0	--	0.0	4713	1,723	8.1	26%	2.1	2357	5,058	11.9	39%	4.6
EDFE EPN	0	0	0.0	--	0.0	3279	1,677	5.5	27%	1.5	1947	3,596	7.0	43%	3.0
SP Distribution	1848	974	1.8	50%	0.9	592	1,723	1.0	49%	0.5	4605	2,128	9.8	40%	3.9
SP Manweb	1092	1,007	1.1	50%	0.6	584	1,712	1.0	49%	0.5	3785	2,114	8.0	39%	3.1
SSE Hydro	250	2,000	0.5	40%	0.2	3957	1,592	6.3	49%	3.1	3268	2,387	7.8	36%	2.8
SSE Southern	70	0	0.0	--	0.0	16703	1,461	24.4	44%	10.8	15945	1,812	28.9	19%	5.4
Total	6496		23.9		8.4	50317		80.9		29.2	56017		156.1		53.4

1.10. A number of DNOs have indicated that they only carry out sole-use connections for small scale LV domestic and one-off commercial connections and they do not make any connections subject to the apportionment rule in this category.

1.11. The ex-ante allowance has been set based on the DNOs' run-rate expenditure and committed large connection schemes. The fixed ex-ante allowance is given in Table 4 below.

Table 4 - LVHC connections ex-ante allowance

DNO £m (07/08 prices)	DPCR4 Actuals	DPCR5 Forecast	DPCR5 Baseline	Reduction from DNO Forecast	Reduction (%)	DPCR5 Volume
CN West	21.2	12.6	12.6	0.0	0%	17
CN East	52.4	49.9	45.9	4.0	8%	48
ENW	35.8	6.3	6.3	0.0	0%	125
CE NEDL	2.6	9.2	5.3	3.9	42%	13
CE YEDL	2.7	14.3	5.6	8.7	61%	33
WPD S Wales	3.6	3.0	3.0	0.0	0%	20
WPD S West	8.0	5.4	5.4	0.0	0%	10
EDFE LPN	3.1	8.5	8.5	0.0	0%	23
EDFE SPN	13.7	41.4	35.6	5.8	14%	96
EDFE EPN	12.3	24.6	12.3	12.3	50%	28
SP Distribution	1.3	11.1	11.1	0.0	0%	7
SP Manweb	16.9	36.4	36.4	0.0	0%	64
SSE Hydro	12.6	10.5	10.1	0.4	4%	1575
SSE Southern	15.1	42.6	40.7	1.9	4%	22
Total	201.3	275.7	238.7	37.0	13%	2080

Rising and Lateral Mains

1.12. As noted in Initial Proposals, some DNOs have forecast costs for the inspection and replacement of rising and lateral mains (RLM) in large scale housing estates. The extent of issues with RLM varies widely across the licensed areas, as does the extent to which ownership has been established. We have now carried out a further review of evidence supplied by the DNOs. We discuss the DNOs' forecasts and our proposed funding arrangements below.

WPD, CN and ENW

1.13. WPD, CN and ENW have not forecast costs associated with RLM for DPCR5 as they do not consider there to be a significant issue within their areas that is likely to lead to costs in DPCR5. However, they do consider that there is potential liability for some costs within the period.

CE and SSE

1.14. Both CE and SSE have given assurance that they own and are responsible for the replacement of RLM included in their forecasts and have provided strong evidence to support the volumes of work forecast, including details of known sites, sampling and surveys carried out.

SP

1.15. SP's forecast expenditure for RLM is by far the highest of the DNO groups. They have provided comprehensive and compelling evidence detailing the volume and nature

of works required but there is an unresolved question around ownership and therefore who funds this work. SP consider that they have a responsibility to replace life expired RLM to ensure public safety irrespective of ownership and responsibility for funding.

EDFE

1.16. For the DNOs within the EDFE group there remains uncertainty over ownership of RLM. There is currently a determination in progress to settle ownership for some of these assets. This determination will give more clarity as to the scope of works required and the potential costs but it is unlikely that this will conclude prior to Final Proposals. It is unclear whether the conclusion of the EDF Energy determination will provide a wide ranging precedent for dealing with RLM assets; the individual circumstances of when the assets were built and regional practices at that time may influence how relevant the findings are to other DNO areas.

1.17. In light of the issues and uncertainties highlighted above we propose to include an ex-ante allowance to provide interim funding for these costs, after which allowances will be reassessed through a reopener. We are currently considering the timescales for providing interim funding and propose two years, during which time the DNOs will be obliged to endeavour to resolve ownership. Those DNOs that have not forecast costs will also have the opportunity to research potential issues.

1.18. Although we are providing some ex ante funding for the first two years we will, at the next price control review and/or as part of the reopener, seek evidence from the DNOs that they have established ownership and sought to recover the costs from customers where appropriate. Where the costs have been recovered directly from customers or where DNOs have not used all reasonable endeavours to establish ownership we may claw back some (or all) of these allowances.

1.19. Table 5 below sets out the DNO's forecasts and Ofgem's ex-ante allowances for expenditure on Rising and Lateral Mains.

Table 5 – Rising and lateral mains

Rising Mains and Laterals									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
CN_East	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
ENW	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
CE_NEDL	0.0	4.0	-	1.6	-2.4	-59%	-2.4	1.6	-
CE_YEDL	0.2	5.9	3342%	2.4	-3.5	-59%	-3.5	2.2	1307%
WPD_S_Wales	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
WPD_S_West	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
EDFE_LPN	0.0	0.5	-	0.0	-0.5	-100%	-0.5	0.0	-
EDFE_SPN	0.7	1.0	43%	0.0	-1.0	-100%	-1.0	-0.7	-100%
EDFE_EPN	0.0	0.5	-	0.0	-0.5	-100%	-0.5	0.0	-
SP_Distribution	4.8	38.6	697%	12.4	-26.2	-68%	-26.2	7.6	156%
SP_Manweb	0.3	21.3	7507%	7.0	-14.3	-67%	-14.3	6.7	2400%
SSE_Hydro	1.4	1.5	7%	0.6	-0.9	-60%	-0.9	-0.8	-57%
SSE_Southern	3.3	5.0	52%	2.0	-3.0	-60%	-3.0	-1.3	-39%
Total	10.7	78.3	632%	26.0	-52.2	-67%	-52.2	15.3	143%

1.20. EDFE's current forecast expenditure relates to inspections, and no money has been included for asset replacement costs. We therefore propose to assess this expenditure as part of EDFE's Inspections and Maintenance allowance.

HILP

1.21. Our Initial Proposals document provides background to the discussion around High Impact Low Probability (HILP) expenditure. Table 6 below sets out the DNOs' forecasts for expenditure regarding HILP events. For the purposes of initial proposals we applied a modelling assumption to include these costs as forecast, pending further clarification of the requirements. We have now updated our baseline view as shown in the table below.

Table 6 - HILP

HILP									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	0.0	5.7	N/A	0.0	-5.7	-100%	-5.7	0.0	-
CN_East	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
ENW	0.0	2.8	N/A	0.0	-2.8	-100%	-2.8	0.0	-
CE_NEDL	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
CE_YEDL	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
WPD_S_Wales	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
WPD_S_West	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
EDFE_LPN	0.2	50.8	N/A	0.0	-50.8	-100%	-50.8	-0.2	-100%
EDFE_SPN	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
EDFE_EPN	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
SP_Distribution	0.0	1.0	N/A	0.0	-1.0	-100%	-1.0	0.0	-
SP_Manweb	0.0	1.6	N/A	0.0	-1.6	-100%	-1.6	0.0	-
SSE_Hydro	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
SSE_Southern	0.0	0.0	N/A	0.0	0.0	0%	0.0	0.0	-
Total	0.2	61.9	N/A	0.0	-61.9	-100%	-61.9	-0.2	-100%

1.22. HILP investments have been proposed in only five of the fourteen licence areas, totalling £61.9m. EDFE's submission for London represents 82 per cent of this expenditure. Scottish Power has proposed HILP investments of £2.6m for specific parts of its networks that are not Central Business Districts (CBDs).

1.23. Since Initial Proposals we have facilitated discussion between DECC and EDFE, as set out in our letter of 24 July, to refine the estimates for the London HILP scheme to better understand the key risk scenarios, the available options to address them, the extent of the works involved and the benefits that would be delivered. These discussions considered whether any alternative measures (other than straightforward electrical reinforcement) could deliver similar resilience benefits at lower cost.

1.24. There are two key issues that need to be considered. First, whether the case has been made for the expenditure in terms of the risks regarding the resilience of substation supplies and whether the proposed solutions are appropriate. Second, whether the costs should be funded by all London customers or the specific customers in business districts that will benefit from the investment and the increased resilience this would deliver. We recognise how important electricity supply reliability may be to business districts such as the City of London and are looking for DNOs to explore further the extent to which these customers are willing to pay for this increased security. There are potentially other options for these customers to increase the resilience of their supplies, such as back-up sites, having access to stand-by generation. We think it is important that they are given the information about the cost of providing increased resilience so that they can determine whether they are willing to pay for this increased resilience or whether they would prefer to achieve this level of resilience through other means. We also encourage other DNOs to explore this issue further with stakeholders in the same way as proposed for London. Ofgem can provide co-ordination of this process to ensure that all proposals are considered on a consistent basis.

1.25. If the issues relating to funding of HILP remain unresolved we will propose that these costs are logged up together with CNI and black start. Beyond a combined threshold level of materiality the DNOs will be able to apply for a reopener. It is important to note that there may be no HILP allowance within DPCR5 as, if there is need for expenditure, the majority of these costs may be recovered from specific customers rather than through the price control.

BT21CN

1.26. 'BT 21st Century Network' (BT21CN) refers to a series of proposed changes to BT's communication network which may impact on circuits leased by the DNOs for protection signalling and substation communication. In Initial Proposals we presented the DNOs' June FBPQ forecasts for works related to BT21CN. Since June BT has presented an update of their plans to the industry², giving more certainty as to which services will continue to be supported and the expected timescales. In particular BT has indicated that the leased line services currently used by the DNOs will continue to be provided until 2018, whilst economically viable. They have also indicated that costs related to these services are expected to increase as the customer base reduces.

1.27. In light of this information we asked the DNOs to provide an updated high level forecast of expenditure. With the exception of SP, the DNOs have not revised their June forecasts in light of BT's latest position. Key justification for maintaining their current forecasts include:

- their forecasts already represent a pragmatic view on the continued availability of legacy private circuit services from BT,
- there is no certainty that the proposal made by BT at the NGN group can be delivered,
- there are other work programmes dependent on the outputs delivered by BT21CN investment,
- BT's latest position is no different to their previous positions, i.e. there is no guarantee that BT can or will continue to provide these legacy services until 2018,
- their submission was based on an eight year project programme from 2010 to 2017, with completion by January 2018, which is consistent with understanding of the latest advice from BT

1.28. In contrast SP have reduced their forecast by £21.3m from £33.3m to £12.0m for their two licence areas. SP indicated that "*Following the NGN workshop we have reconsidered our plans for BT21CN over DPCR5 and DPCR6 to acknowledge BTs "2018 switch off" for the platform associated with the analogue leased lines. To minimise the cost impact on customers during DPCR5, we have re-profiled and reduced our expenditure investment in DPCR5, and "tail ended" the expensive and complicated solutions into DPCR6*".

1.29. In addition SP requested "*In the event that BT do not honour the 2018 switch off, (as declared at the ENA NGN meeting) and accelerate their termination of the leased lines platform used for the "EPS25B analogue leased lines", we expect that a re-opener clause would be available in DPCR5*".

1.30. Based on our understanding of BT's current position and the approach adopted by SP our view is that there is scope to defer some of the forecast expenditure into DPCR6 where this represents the lowest lifetime cost for customers.

1.31. SP's updated forecast corresponds to a deferment of their original BT21CN programme by approximately 2 to 3 years, into DPCR6. This is impacted by SP's original

² ENA Next Generation Networks (NGN) working group, 5th August 2009

forecast having a front end profile, in contrast to a number of other DNOs with a more backend profile. For these DNOs a 2 to 3 year deferment would result in a considerably larger percentage reduction to their DPCR5 forecast than that represented by SP's updated forecast.

1.32. Taking account of the above our proposals for BT21CN are:

- to provide an ex-ante allowance,
- with the exception of SP, to defer all DNO forecasts by 1 year,
- to subject programmes greater than £15m to the high value project mechanism³, and
- to update our calculation at Final Proposals based on detailed unit cost analysis⁴.

1.33. The latest DNO forecasts and our proposals for BT21CN are shown in Table 7 below.

Table 7 – BT21CN

BT21CN									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	0.0	8.9	-	6.7	-2.3	-25%	-2.3	6.7	-
CN_East	0.0	23.4	-	16.3	-7.0	-30%	-7.0	16.3	-
ENW	5.0	19.6	290%	19.6	0.0	0%	0.0	14.5	290%
CE_NEDL	0.0	2.3	-	2.3	0.0	0%	0.0	2.3	-
CE_YEDL	0.0	3.2	-	3.2	0.0	0%	0.0	3.2	-
WPD_S_Wales	0.1	2.6	3600%	2.6	0.0	0%	0.0	2.5	3600%
WPD_S_West	0.1	0.8	636%	0.8	0.0	0%	0.0	0.7	636%
EDFE_LPN	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
EDFE_SPN	0.0	23.5	-	16.4	-7.1	-30%	-7.1	16.4	-
EDFE_EPN	0.6	42.2	6933%	26.8	-15.4	-36%	-15.4	26.2	4367%
SP_Distribution	0.0	1.5	-	1.5	0.0	0%	-4.0	1.5	-
SP_Manweb	3.5	10.5	202%	10.5	0.0	0%	-17.3	7.0	202%
SSE_Hydro	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
SSE_Southern	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
Total	9.3	138.4	1394%	106.7	-31.8	-23%	-53.1	97.4	1051%

CNI security

1.34. The Centre for Protection of National Infrastructure (CPNI) is currently reviewing key sites identified by the DNOs to establish the need case for enhancement of physical security provisions. This work has not yet developed to the point where DECC has required any of the DNOs to carry out work. In their forecasts two DNO groups (CN and SP) have taken the view that they will be required to act during DPCR5. The remainder have not provided a forecast as no instructions have been received. Table 8 below shows the DNOs' forecasts for CNI security.

³ Our proposals for high value projects were highlighted in "Initial Proposals – Allowed revenue - Cost assessment"

⁴ In addition to their updated high level forecast the DNOs were requested to provide a more detail breakdown of their costs to allow detailed benchmarking of unit costs. This information has only recently been received and does not feed into these proposals.

Table 8 – CNI security

CNI security									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	0.0	2.4	-	0.0	-2.4	-100%	-2.4	0.0	-
CN_East	0.0	2.4	-	0.0	-2.4	-100%	-2.4	0.0	-
ENW	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
CE_NEDL	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
CE_YEDL	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
WPD_S_Wales	0.1	0.0	-100%	0.0	0.0	0%	0.0	-0.1	-100%
WPD_S_West	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
EDFE_LPN	4.7	0.0	-100%	0.0	0.0	0%	0.0	-4.7	-100%
EDFE_SPN	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
EDFE_EPN	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
SP_Distribution	0.0	5.0	-	0.0	-5.0	-100%	-5.0	0.0	-
SP_Manweb	0.0	6.0	-	0.0	-6.0	-100%	-6.0	0.0	-
SSE_Hydro	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
SSE_Southern	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
Total	4.8	15.8	230%	0.0	-15.8	-100%	-15.8	-4.8	-100%

1.35. We are not proposing an ex-ante allowance. Instead we propose to put in place a mechanism to fund security enhancements to DNO sites if required, allowing the DNOs to log up costs as they are incurred, together with HILP and black start, and subjecting these costs to an ex-post efficiency review. We will require the DNOs to demonstrate not only that they have implemented the work efficiently for relevant sites, based on competitive tenders, but also that they have engaged effectively with all interested parties to ensure an appropriate balance between cost and risk and that alternative solutions have been considered. The logging up mechanism will apply to 95 per cent of incurred costs to encourage efficiency in this area.

1.36. We propose that the DNOs report these costs to DECC and Ofgem on a quarterly basis, subject to a full annual review and potential audit.

Black start capability and emergency batteries

1.37. In Initial Proposals we provided background on the work which is being carried out by the Energy Emergencies Executive Committee (E3C) in conjunction with DECC and the industry regarding ability to restore supplies in the event of a system black start. E3C is considering current and future resilience risks and the likely investment that may be necessary to mitigate them, with work due to be completed in 2010. This work will determine whether a national standard is required in this area, and will influence the level of investment which may be required of the DNOs.

1.38. Table 9 below sets out the DNO forecasts for expenditure regarding black start capability and emergency batteries.

Table 9 – Black start capability and emergency batteries

Black Start Capability & Emergency Batteries									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	0.0	0.5	-	0.0	-0.5	-100%	-0.5	0.0	-
CN_East	0.0	0.5	-	0.0	-0.5	-100%	-0.5	0.0	-
ENW	0.0	0.0	-	0.0	0.0	0%	0.0	0.0	-
CE_NEDL	0.0	3.7	-	0.0	-3.7	-100%	0.0	0.0	-
CE_YEDL	0.0	9.0	-	0.0	-9.0	-100%	0.0	0.0	-
WPD_S_Wales	0.0	2.0	-	0.0	-2.0	-100%	-2.0	0.0	-
WPD_S_West	0.0	1.4	-	0.0	-1.4	-100%	-1.4	0.0	-
EDFE_LPN	0.0	6.6	-	0.0	-6.6	-100%	-6.6	0.0	-
EDFE_SPN	0.0	9.0	-	0.0	-9.0	-100%	-9.0	0.0	-
EDFE_EPN	0.0	21.0	-	0.0	-21.0	-100%	-21.0	0.0	-
SP_Distribution	0.0	0.7	-	0.0	-0.7	-100%	-0.5	0.0	-
SP_Manweb	0.0	1.6	-	0.0	-1.6	-100%	-1.0	0.0	-
SSE_Hydro	0.0	6.0	-	0.0	-6.0	-100%	-6.0	0.0	-
SSE_Southern	0.0	8.0	-	0.0	-8.0	-100%	-8.0	0.0	-
Total	0.0	70.0	-	0.0	-70.0	-100%	-56.6	0.0	-

1.39. Five of the seven DNO groups have submitted costs for black start capability and/or emergency batteries, with expenditure forecasts dominated by EDFE and SSE. Since Initial Proposals we have issued further supplementary questions to ascertain the potential materiality of the issue. We asked the DNOs to submit additional forecasts for black start capability and emergency battery costs given the following scenario:

- all works required to be complete within DPCR5,
- applicable substation sites to be identified using the criteria currently proposed under ETG Workstream 5, and
- 72 hour resilience for DNO auxiliary supplies required.

1.40. We propose that the cost of black start capability and emergency batteries should be logged up together with the costs of CNI security and HILP subject to a materiality threshold. Beyond this threshold DNOs will be able to apply for a reopener. All logged costs will be subject to an ex-post efficiency review.

Major system risks expenditure – Flooding

1.41. An overview of initial proposals for flooding expenditure is presented in Table 10 below.

Table 10 - Major system risks expenditure – flooding

Flooding									
DNO £m (07/08 prices)	DPCR4 actuals	DPCR5 Forecast	Difference (%)	Sept Update Baseline	Reduction from DNO Forecast	Reduction (%)	Change from IP	Increase: DPCR4 to Baseline	Increase (%)
CN_West	0.3	2.4	690%	2.4	0.0	0%	0.4	2.1	690%
CN_East	0.1	8.4	9781%	8.4	0.0	0%	1.5	8.3	9781%
ENW	3.2	7.4	135%	7.4	0.0	0%	1.6	4.3	135%
CE_NEDL	0.6	3.2	433%	1.8	-1.4	-45%	-0.7	1.2	193%
CE_YEDL	2.1	29.6	1305%	29.0	-0.6	-2%	22.1	26.9	1278%
WPD_S_Wales	1.0	10.8	986%	10.8	0.0	0%	2.6	9.8	991%
WPD_S_West	1.0	6.8	576%	6.3	-0.5	-7%	0.2	5.3	530%
EDFE_LPN	0.5	4.1	720%	4.1	0.0	0%	0.7	3.6	720%
EDFE_SPN	0.5	6.0	1100%	6.0	0.0	0%	0.3	5.5	1100%
EDFE_EPN	0.6	7.5	1150%	7.5	0.0	0%	0.9	6.9	1150%
SP_Distribution	0.3	3.2	942%	2.7	-0.5	-17%	0.0	2.4	768%
SP_Manweb	0.2	11.4	5731%	11.4	0.0	0%	4.9	11.2	5731%
SSE_Hydro	0.0	2.7	-	0.2	-2.4	-91%	-1.1	0.2	-
SSE_Southern	0.0	9.0	-	0.2	-8.8	-98%	-4.3	0.2	-
Total	10.4	112.3	985.1%	98.1	-14.2	-13%	29.2	87.8	848%

1.42. Ofgem’s proposals for the expenditure on flood protection have been derived from analysis of the following cost categories:

- forecast expenditure on super grid, bulk supply points and primary substations,
- forecast expenditure on site surveys, and
- forecast expenditure for non site specific costs, such as portable flood defences.

1.43. We have analysed the forecast change in risk exposure to flooding. We have calculated the change in risk by combining the likelihood of flooding (1/100, 1/200 and 1/1000) with the number of customers at risk at each site. We have also factored in “critical customers” (such as hospitals) by applying a higher weighting to them, where they have been identified.

1.44. Given the range of sites and factors involved we have used the upper quartile £ per risk reduction as the benchmark which is 20 per cent higher than the average. Where the DNO’s forecast is above the upper quartile £ per risk reduced we have scaled back their forecast by the percentage they are above the upper quartile £ per risk reduced. Where DNOs are below the upper quartile £ per risk reduced we have given them their own forecast.

1.45. For two DNOs their latest forecast numbers were not sufficiently detailed to be included in the above analysis and no ex-ante allowances have been included. If their information is not more detailed in time for Final Proposals then we will not be in a position to give an ex-ante allowance.

1.46. For site surveys we have allowed DNOs the minimum of their own forecast and the DPCR4 average expenditure on site surveys by those DNOs undertaking site surveys in DPCR4.

1.47. For non-site specific flood related expenditure we have allowed DNOs the minimum of their own forecast and DPCR4 average non-site specific expenditure for those DNOs that made expenditure in this area.

Technical Losses

1.48. In Initial Proposals we explained that the DNOs were asked to submit their proposals for incremental expenditure to reduce technical losses on the basis of a nominal loss incentive value set at £86/MWh (which was calculated using the methodology proposed in the December Policy Paper) but that we had assessed the

proposals based on the value of loss incentive proposed in Initial Proposals, that is £60/MWh.

1.49. We stated that we would work with the DNOs to finalise their proposed expenditures to reduce losses by September.

1.50. We have therefore provided a detailed explanation⁵ to the DNOs of how we assessed the proposals and given them the opportunity to revise their proposals based on this assessment. As part of this explanation we also highlighted that we had changed our assessment criteria slightly, based on the Information Quality Incentive (IQI) figures included in Initial Proposals. This meant that two additional loss reduction schemes with a value of £4.2m were added to the £11.4m identified in Initial Proposals.

1.51. None of the DNOs submitted revised proposals, meaning that the total DPCR5 baseline for technical losses is £15.6m. The breakdown is shown in Table 11.

Table 11 - Incremental expenditure to reduce technical losses

Losses						
DNO £m	DPCR5 forecast	Sept Update Baseline	Reduction from DNO forecast	Reduction (%)	Change from IP	losses target reduction (MWh)
CN_West	2.0	2.0	0.0	0%	0.0	13,878
CN_East	1.3	1.3	0.0	0%	0.0	8,953
ENW	1.8	1.8	0.0	0%	0.0	3,982
CE_NEDL	0.0	0.0	0.0	0%	0.0	0
CE_YEDL	0.0	0.0	0.0	0%	0.0	0
WPD_S_Wales	0.0	0.0	0.0	0%	0.0	0
WPD_S_West	0.0	0.0	0.0	0%	0.0	0
EDFE_LPN	0.0	0.0	0.0	0%	0.0	0
EDFE_SPN	0.0	0.0	0.0	0%	0.0	0
EDFE_EPN	0.0	0.0	0.0	0%	0.0	0
SP_Distribution	5.2	2.7	2.4	47%	2.1	4,352
SP_Manweb	4.4	2.6	1.8	42%	2.1	4,075
SSE_Hydro	4.3	1.0	3.3	76%	0.0	2,499
SSE_Southern	14.3	4.1	10.2	71%	0.0	8,198
Total	33.3	15.6	17.7	53%	4.2	45,936

1.52. The loss targets for the DNOs with allowed incremental expenditures to reduce losses will be adjusted to factor the loss reductions that a DNO has forecast will occur because of these investments, as shown in Table 11.

Discretionary Expenditure

1.53. In Initial Proposals we set out the DNO forecasts for non-core expenditure that the DNOs could justify, over and above normal business expenditures in order to

⁵ Based on the data submitted in the FBPQ we calculated the cost per MWh incremental loss reduction from the per-unit incremental loss reduction (MWh p.a.) and the per-unit incremental cost (£) for each proposed incremental loss reduction expenditure. We compared this against the effective value of the loss incentive over the five year price control period calculated as the value of the loss incentive (per MWh per year) plus the impact of the Information Quality Incentive (IQI). This evaluation uses the current regulatory framework as the basis – which we compared against the value of the losses incentive without the current regulatory framework (i.e. as if the DNO gained a benefit of the loss incentive for every year of the 20 year investment life). This produced a very similar result.

increase future network flexibility (which we termed Discretionary Expenditure). The DNOs forecast a total of £112.9m over the DPCR5 period. We explained that we had assessed the Discretionary Expenditure according to the quality of the proposals, and concluded that the DNOs had provided insufficient justification to be able to assess the schemes. Our Initial Proposals therefore did not include any discretionary expenditure in the baseline.

1.54. We invited the DNOs to develop stronger proposals and to submit these to us by September, along with detailed and thorough justification.

1.55. One DNO, WPD, submitted a more thorough proposal for their proposed investment of £54.5m to cover the installation of smart meters at LV/HV substations across both of their networks. We are currently discussing the proposal with WPD, and are considering whether the proposal should be more focused using a more targeted trial. We see this proposal as an ideal candidate for the Low Carbon Network (LCN) fund, but recognise that there are advantages to the trial starting at the start of DPCR5 rather than wait for the first call and approval from the LCN fund (which could be at least another six months). We are therefore considering options with WPD to start the project as ex-ante discretionary expenditure, possibly with further funding through the LCN fund.

1.56. No other DNOs have indicated that they want to submit more detailed investment forecasts under this category. We understand that they intend to make use of the LCN fund instead. The DNO detail is shown in Table 12 below.

Table 12 - Discretionary expenditure

Discretionary expenditure					
DNO £m	DPCR5 forecast	Sept Update Baseline	Reduction from DNO forecast	Reduction (%)	Change from IP
CN_West	7.0	0.0	7.0	100%	0.0
CN_East	10.8	0.0	10.8	100%	0.0
ENW	0.0	0.0	0.0	0%	0.0
CE_NEDL	0.0	0.0	0.0	0%	0.0
CE_YEDL	0.0	0.0	0.0	0%	0.0
WPD_S_Wales	23.8	to be assessed			
WPD_S_West	30.7				
EDFE_LPN	5.0	0.0	5.0	100%	0.0
EDFE_SPN	11.0	0.0	11.0	100%	0.0
EDFE_EPN	14.0	0.0	14.0	100%	0.0
SP_Distribution	0.6	0.0	0.6	100%	0.0
SP_Manweb	1.5	0.0	1.5	100%	0.0
SSE_Hydro	4.0	0.0	4.0	100%	0.0
SSE_Southern	4.5	0.0	4.5	100%	0.0
Total	112.9	0.0	58.4	52%	0.0

Appendix 2 - Network investment policy appendix

Question 1: Do you consider our proposals for an application window to be appropriate?

Question 2: Do you consider our proposed approach for TMA costs to be appropriate?

Question 3: Do you consider our proposals for assessment of the load related reopener to be appropriate?

Application window for reopeners

1.1. We are proposing to introduce an application window for the reopeners relating to TMA and load related expenditure and also for the logged up expenditure items in the section below where they meet a predefined materiality threshold. The application window would be the same for each of these items. We are considering this approach so that the frequency of reopeners is reduced giving greater predictability in charges over the DPCR5 period and also so that Ofgem can consider the reopeners collectively and make suitable comparisons between DNOs to assess efficient levels of expenditure.

1.2. We currently propose that this application window would be at the end of the second year of the price control i.e. March 2012 and any DNOs that had made applications during this period would receive a determination within 4 months (assuming that sufficient information had been provided to Ofgem).

1.3. We welcome views on this approach and the best point in time to place this window.

The Traffic Management Act (TMA)

1.4. We set out in initial proposals some of the difficulties we were having understanding the different forecasts put forward by the DNOs for their traffic management costs. Further analysis and discussions with the DNOs have revealed some of the differences in interpretations of how permitting schemes would operate. For example, some DNOs were assuming that permits would replace notices in their entirety on a one-for-one basis, while others were assuming that permits would be an additional requirement on top of the current noticing requirements.

1.5. We have had discussions with DfT, Kent County Council (the first council to have had a permitting scheme approved) and DNOs and now have a better understanding of the implications of the introduction of permitting schemes. For the approved Kent scheme, it appears the main difference between the current arrangements and the proposed permitting scheme is that any notifications under Sections 54, 55 and 57 of NRSWA will be replaced by a permit requirement.

1.6. It is also clear from the schedule of Permit Fees in the Kent scheme that authorities will have significant discretion in setting the fees for different kind of permits which will affect DNOs in different ways. For example, Kent has decided not to charge for permits associated with several types of activities.

1.7. Given the continued uncertainty over the timing and level of permit fees we have decided to set out proposals for traffic management costs on the following basis:

- We will set an ex-ante allowance for traffic management excluding any permitting costs, and under the assumption that no permitting schemes will be introduced.
- We will consider additional costs arising from the introduction of permitting schemes will be assessed as part of a reopener during DPCR5 (where DNOs put forward an application) or at DPCR6.

1.8. Our approach on each of these points is set out below.

Ex-ante allowance for traffic management costs (excluding permitting)

1.9. We asked all of the DNOs to re-submit their traffic management cost forecasts assuming there will be no introduction of permitting schemes to put all DNOs submissions on to the same basis. We have conducted some initial analysis on these resubmissions which are presented in the table below. There still remain some inconsistencies between DNOs – e.g. some have reported the number of works whereas others have reported the number of notifications. To put all the DNOs submissions onto the same basis we have converted the volume of works into the number of notifications using an assumption of 4 notifications per works which is an assumption used by most of the DNOs who have reported on this basis.

Table 13 - Initial TMA analysis results (£m)

	Noticing	Inspections	One-off set up costs	Other	Total	% of DNO forecast
CN_East	0.6	2.6	0.0	0.8	3.9	100%
CN_West	0.5	2.4	0.0	0.6	3.5	100%
ENW	2.3	4.4	0.0	1.0	7.6	93%
CE_NEDL	0.5	0.4	0.0	0.1	1.0	89%
CE_YEDL	1.0	0.7	0.0	0.3	2.0	88%
WPD_S_Wales	0.9	0.3	0.0	0.2	1.4	92%
WPD_S_West	1.3	1.2	0.0	0.2	2.7	94%
EDFE_LPN	0.8	1.7	4.3	3.8	10.6	98%
EDFE_SPN	0.7	1.4	1.2	0.9	4.1	98%
EDFE_EPN	1.2	2.5	2.3	2.5	8.5	97%
SP_Distribution	0.8	1.2	1.1	2.0	5.1	97%
SP_Manweb	0.9	1.5	1.1	1.6	5.1	70%
SSE_Hydro	0.3	0.1	0.0	0.6	1.0	88%
SSE_Southern	0.0	2.1	0.0	0.2	2.3	94%
Total	11.6	22.5	9.9	14.8	58.8	93%

1.10. In the table above "Other" refers to costs relating to: lane rentals, overstay fines, and the congestion charge.

1.11. So far the only adjustments we have made to the DNOs' forecasts are for the penalties associated with notices and inspections. We have:

- removed excess noticing penalties where DNOs have assumed more than 5 per cent of notifications will result in a penalty,
- removed excess inspection penalties where DNOs have assumed more than 10 per cent of inspections will result in a penalty, and
- we have capped average noticing penalties at £84 on the assumption that an efficient DNO can pay 90 per cent of penalties within 28 days at the discounted rate of £80 and 10 per cent at the full rate of £120.

1.12. A review of the submissions made by the DNOs suggests these rates of penalties can be achieved by efficient DNOs. Indeed there are some DNOs that have forecasted penalty rates below these levels. We also think that paying 90 per cent is also achievable – some DNOs have a policy of paying all penalties within this period – assuming 10 per cent to be paid at the full rate allows the DNOs time to challenge penalties were appropriate.

1.13. The results of the analysis presented above do not include traffic management administration costs. We have decided to remove these costs from the analysis in this

area and instead include them with the operating cost regression for Group 2 indirects. We have taken this decision for two reasons:

- The costs included within traffic management admin costs varies by DNO: any comparison would not be comparing like with like.
- Some DNOs have not stripped these costs from their historical figures and so they are already included within the Group 2 regression. If were to allow these costs under traffic management also then such DNOs could receive an allowance for the same costs twice.

1.14. Going forward we plan to get the DNOs to resubmit their traffic management figures again so that inconsistencies revealed in the latest round of analysis can be removed. The areas that we will be looking to resolve include:

- an assessment of one-off costs,
- an assessment that volumes of works are consistent with the results of our cost assessment,
- ensuring DNOs report noticing on the same basis,
- ensuring DNOs report costs in the same prices – not all costs submitted so far have been in 2007-08 prices,
- checking that traffic management costs associated with connections outside of the price control have been recorded on a consistent basis, and
- ensuring that there is consistent reporting between DNOs where traffic management penalties have been shared between the DNO and their contractors.

1.15. We shall be seeking further clarifications from the DNOs to ensure that reporting is consistent and will refine our approach once these issues have been resolved.

Reopener for the introduction of permitting schemes

1.16. We propose a reopener for the introduction of permitting schemes. This reopener will provide the DNOs with protection against:

- the timing of the introduction of permitting schemes,
- the average incremental costs of permits over notices (including penalty costs),
- efficient one-off set up costs associated with permitting (over and above those that are already funded), and
- efficient additional administration costs associated with permitting.

1.17. The reopener will not provide protection against the following:

- volumes of activity i.e. the number of works,
- the proportion of notices/permits that are subject to penalties, or
- any other changes to the traffic management regime e.g. inspections or lane rentals.

1.18. In the points below we set out some more details of how we propose the reopener will operate:

- We propose that by default any costs associated with permitting will be logged up and assessed at DPCR6 under the same rules as the reopener. DNOs may also initiate a reopener during the application window if they have 12 months of cost data relating to permitting within the DPCR5 period. Once this reopener request has been made with the appropriate supporting information, Ofgem would make a determination within a 4 month period. The reopener would only consider the areas with this 12 months of supporting permitting data. Permitting costs in other areas would be logged up and considered at DPCR6.

- In assessing the additional costs of permits over notices our approach will be mechanistic. Our baseline allowance for each DNO will be based on an assumed number of works/notices, an assumed penalty rate, and an assumed cost per notice (zero) and per penalty. When revising allowances we will only consider the proportion of notices that have been replaced by permits and the associated differences in costs between our notice assumption and the actual average costs for permits. These differences will then feed back through our original volume and penalty rate assumptions to calculate revised allowances, and
- Our assessment of the efficiency of any one-off set up costs and additional administration costs we will be based on the information submitted by the DNO and compared with the information available from other DNOs and other industries (e.g. gas distribution).

The reopener for load-related expenditure

1.19. We propose to include a reopener for load related expenditure associated with general reinforcement and the shared element of high-cost low-volume connections that is DUoS funded. In Initial Proposals we suggested that DNOs could trigger the reopener if they could demonstrate a net 20 per cent greater efficient expenditure on connections and general reinforcement compared to the Ofgem baseline. We set out that we expect them to justify this increase in efficient expenditure requirement through use of the load index output measures and the volume of high cost connections. In forming this assessment we would also consider any offsetting impact from efficient DSM activities to avoid general reinforcement so that DNOs would not be discouraged from undertaking these activities. Across the industry as a whole this 20 per cent threshold represents around £340 million over the life of the price control.

1.20. We explained that the reopener would be symmetrical and that Ofgem could trigger it at the end of DPCR5 if we determine that expenditure is 20 per cent less than our assumption due to a change in demand and/or fewer high-cost connections. In making this assessment we would take into account the impact of efficient DSM activities to avoid general reinforcement.

1.21. As discussed above, we propose to introduce an application window for the reopener to allow us to consider such reopeners at the same time and also to reduce revenue volatility within the price control period. When a DNO applies for a reopener within this window we would expect the following information to be contained within the application:

- Data on the volume and unit costs of high cost connections. The contribution of this element towards the 20 per cent threshold would be calculated as efficient expenditure on these connections minus the baseline assumed in the price control. If this amount is negative then it would raise the hurdle to be cleared by the general reinforcement element of the reopener.
- On the general reinforcement side of the reopener we expect its contribution towards the threshold to be calculated by summing:
 - The additional net efficient expenditure on reinforcement caused by the combination of actual and forecasted demand being greater than expected. We would expect this increase in demand to be demonstrated through the common framework output measures. This net increase would take into account areas of the network where actual and forecasted demand for the period was less than expected and general reinforcement had been avoided. This avoided expenditure would be subtracted from the additional expenditure required in areas of the network where greater than expected reinforcement was required.
 - The additional general reinforcement that had been avoided by DSM activities.

1.22. Ofgem would review this submission and if the threshold had been met then the price control would be reopened to allow the additional expenditure plus financing costs. We are considering smoothing any adjustment over a number of years to reduce revenue volatility. In making the adjustment we would take into account the working of the RAV rolling incentive to ensure that in NPV terms the DNOs are no worse off from the reopener than a counterfactual where the allowance had been included at the price control.

1.23. At DPCR6 we would make an assessment of whether efficient expenditure was 20 per cent less than forecast at the price control due the outturn of demand and the volume of high-cost connections. This assessment would follow the same approach as the assessment on the upside described above.

Logged up expenditure items

1.24. There are three areas where we are proposing logging up mechanisms:

- CNI,
- black start capability and emergency batteries, and
- HILP.

1.25. By default we propose that these expenditure items will be logged up and considered at DPCR6. However, we are also proposing to introduce a materiality threshold, which if the DNOs can demonstrate will be met over the DPCR5 period then a reopener can be triggered during the application window. We propose that this materiality threshold would apply to the three expenditure items above combined for which the DNOs have forecasted around £150m of expenditure. We welcome views on the appropriate level for this threshold or whether a threshold is unnecessary and expenditure in this area can be logged up in its entirety.

High-volume low-cost connections driver

1.26. In Appendix 1 we set our proposed unit costs for the operation of this mechanism. These unit costs combined with assumed volumes provide the DNOs with an allowance for the DPCR5 period. Any deviations in actual volumes from those assumed will be multiplied by our assumed unit costs to give expenditure that will be trued up at DPCR6. This truing up will be based on an NPV calculation to make DNOs indifferent between extra revenue at DPCR6 and the original allowance reflecting the actual volumes. The truing up will also take into account changes in the net to gross ratio from what we assumed in setting the price control.

Rising and lateral mains reopener

1.27. Our proposals in this area set out in Appendix 1.

Transmission Exit Charges

1.28. DNOs currently pay National Grid for the financing and operating costs of the assets that connect the distribution network to the transmission network. These costs are termed transmission exit charges. Historically DNOs recover these charges fully from customers, and they are considered as revenue outside the price control. While we review these costs within the transmission price control to ensure efficiency, it is not clear that the DNOs have adequate incentives to explore all options on their own networks to ensure efficient development of transmission exit points.

1.29. We proposed in Initial Proposals to set a hybrid arrangement where the elements of exit charges that a DNO can influence are subject to an incentive, whilst those that are outside a DNO's control remain as a cost pass-through.

1.30. We asked the DNOs to forecast the total amount of exit charges they will be liable for during DPCR5 and to indicate the amount related to assets installed during DPCR5, disaggregated according to the main driver of the works (such as replacement, reinforcement or new grid supply point, GSP). This enabled us to identify the exit charges that the DNO could influence. The DNOs submitted forecasts of £118.7m for those transmission exit charges that they can influence (i.e. those associated with increased capacity) over the DPCR5 period.

1.31. Since Initial Proposals we have analysed the DNO forecasts of transmission exit charges and have assessed the accompanying justifications and compared this against information supplied by NGET. This has given rise to a number of inconsistencies that we are currently unable to resolve. As such there needs to be further joint work by the industry and Ofgem to reach a position where there is more consistent information on which we can set an ex-ante allowance for Final Proposals. We propose that a joint meeting should take place by mid October for this purpose.

Appendix 3 - Financial issues appendix

Recovery of bad debts incurred in DPCR4

1.1. Our February 2005 best practice guidelines for gas and electricity network operator credit cover set out the basis on which network operators, including the DNOs, could qualify for recovery of bad debts arising from provision of use of system services. The approach was intended to balance the encouragement of competition (by assuring access to networks for smaller energy companies) with the need to protect consumers from unreasonable risks associated with bad debt costs passed through to them by network operators. The criteria are summarised below.

- Credit cover rules consistent with best practice to have been incorporated into relevant industry codes and the network operator to have acted in accordance with those code requirements.
- In respect of specific claims, the network operator to have taken appropriate steps to minimise their exposure to the bad debt.

1.2. We explained in Initial Proposals that we had received specific applications from two DNOs for recovery of bad debts following the failure of electricity suppliers during the DPCR4 period. We did not have time to assess the validity of these claims against the criteria in advance of publishing Initial Proposals and we needed to seek equivalent information in respect of costs 'logged up' by other DNOs. Therefore, we did not include any amounts in the revenue allowances in Initial Proposals.

1.3. The DNOs have reported that they have incurred approximately £6m in costs during the DPCR4 period to date. Following Initial Proposals we have asked each of the DNOs to submit information confirming that the costs incurred comply with the established best practice guidelines. After scrutiny of the submissions relevant adjustments will be made to DNOs' allowed revenue figures for 2010-11 and reflected in Final Proposals accordingly. At this stage we expect to say that any bad debts expensed or specifically provided for after publication of Final Proposals would need to be logged up by DNOs for consideration at DPCR6.