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Our Ref	*Your Ref*	*Direct Line*	*Date*
	92/09	0117 9332175	4th September 2009

Dear Rachel

Ofgem Consultation: Electricity Distribution Price Control Review Initial Proposals 3rd August 2009

I attach our response to Ofgem's initial proposals.

To help you understand our position on the key points, we have captured these in the attached summary. The answers to the specific questions raised in Ofgem's documents including our detailed comments on cost of capital are set out in a separate annex, which is also attached. These two attachments represent our full response to initial proposals. We have also responded separately to Ofgem's recent pension consultation and, accordingly comments relating to pensions are not included within this response.

You will already be familiar with the main themes within our submission as we covered these at our meeting on August 13 2009. WPD are demonstrably at the efficiency frontier when compared to other DNOs. In terms of our DPCR4 operating and capital investment forecasts, we have bid accurately and delivered against these forecasts. We have delivered outstanding customer service and set the industry benchmark for network performance. In setting allowances for DPCR5, superior performance should be incentivised and rewarded accordingly. In this respect, Ofgem's initial proposals fail and give rise to the unintended consequence of driving companies to a performance that is average in terms of capital efficiency and service delivery rather than upper quartile. Clearly this cannot be in the best interests of electricity customers.

Efficiency has three main considerations;

- Operating costs
- Capital costs
- Service delivery

Operating cost efficiency

Ofgem's analysis of operating costs and modelling is robust; the May paper showed that the relative efficiencies and therefore rankings of the DNOs remain consistent across 26 different types of analysis. Since the publication of the May initial results paper, Ofgem have, inexplicably, failed to adhere to its approach as presented and has introduced a number of changes without justification or explanation. The result of the changes is that while WPD remain the second most efficient performer, we have moved out of the upper quartile. There are two reasons for this;

- Ofgem have introduced adjustments, with no logical basis, which favour inefficient companies. For example, Ofgem's assumptions on labour and contractor adjustments do not reflect market conditions. Adjustments relating to sparsity, density and interconnected networks are also incorrect.
- The setting of allowances for indirect costs is fundamentally flawed. WPD's allowance is reduced by £14m despite being identified as an upper quartile performer. In contrast, CN, a relatively inefficient company, receive an additional £11m.

Capital cost efficiency

The process for developing the initial proposals with respect to core network investment is correct. However, it is inconsistent to recognise operating cost efficiency without also recognising capital efficiency. In evaluating each DNO's asset replacement forecasts, Ofgem have used the lower of the DNO's own unit cost forecast or the all DNO median unit costs. The majority of WPD's asset replacement unit costs are below the all DNO median value. WPD therefore have a material impact on the all DNO median unit cost and excluding WPD from the unit cost dataset means that the median unit cost would increase across a range of asset types. The increase in the baseline asset replacement forecasts for the other DNOs would increase by approximately £100m during DPCR5 when WPD's unit costs are excluded from the determination of the median. Given that capital expenditure accounts for 70% of total costs, customers should benefit from efficiency in this area and Ofgem should recognise the value of having WPD in the dataset. The frontier setting performance of WPD's unit costs makes it much more difficult for them to achieve further unit cost reductions and outperform the IQI mechanism.

Service delivery

On every objective indicator WPD's record of service delivery is second to none. However the initial proposals contain no linkage between efficiency and performance.

At DPCR4 the risk of tough network performance targets was, rightly, recognised financially and the frontier performance set by WPD was rewarded. Initial proposals set CML targets that are significantly tougher than DPCR4 in absolute terms and despite WPD CML performance setting the benchmark for DPCR5 the proposals for the IIS scheme remove any ability to outperform and introduce the prospect of penalties only. Again there is a quantifiable benefit of £38m during DPCR5 resulting from WPD setting the benchmark performance.

Concluding Comments

The operating cost adjustments significantly enhance the allowed operating cost position of the poor service performers.

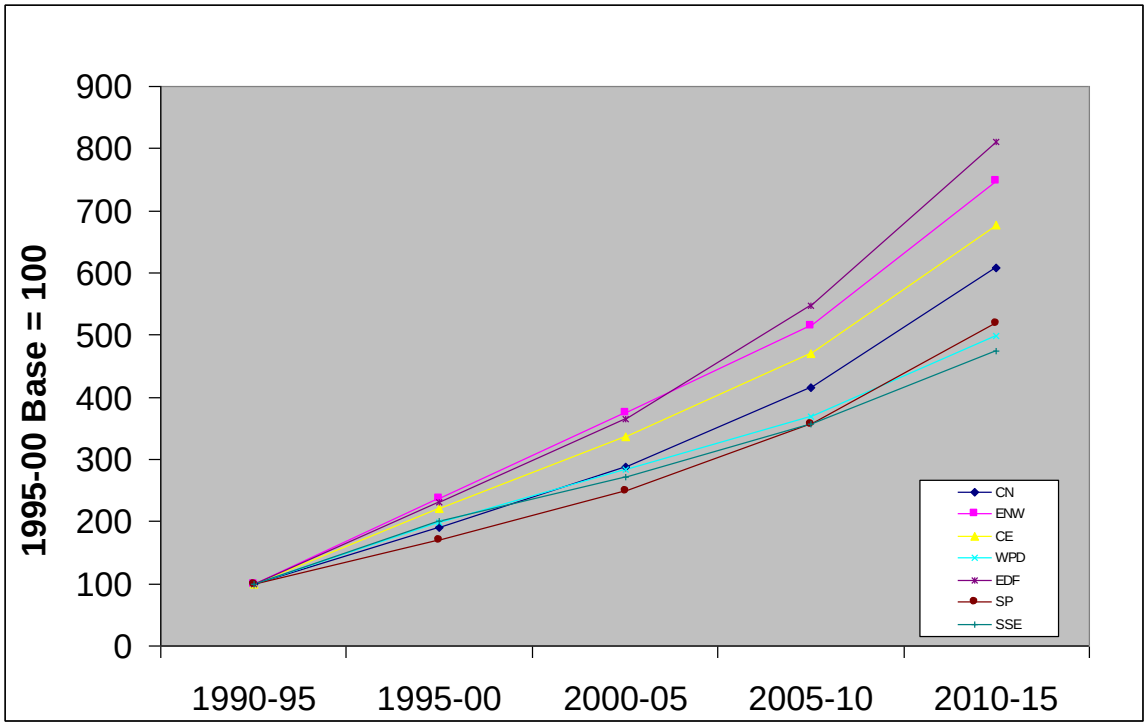
Equalising incentives compounds this position since these same companies have a high ratio of capital to operating cost and so the move to the proposed 85/15% position is less problematic for them than for WPD with the lowest capex/opex ratio.

Allocation of Fast Pot/Slow Pot to DPCR5 Costs Using DPCR4 Rules

2007/08 prices	CNW	CNE	ENW	NEDL	YEDL	SWales	SWest	EDFL	EDFS	EDFE	SP	SPM	SSEH	SSES	Total	WPD
Slow Pot	78%	77%	82%	80%	77%	74%	74%	79%	80%	75%	80%	82%	77%	76%	78%	74%
Fast Pot	22%	23%	18%	20%	23%	26%	26%	21%	20%	25%	20%	18%	23%	24%	22%	26%

Relatively high capex/opex ratios cannot be explained away by differing network topology or different construction standards since for 40 years companies existed in the public sector with standard designs and construction. The answer lies in historic high spend as illustrated in the RAV addition graph below and high unit costs resulting from inefficiency, capex/opex boundary issues and over specification.

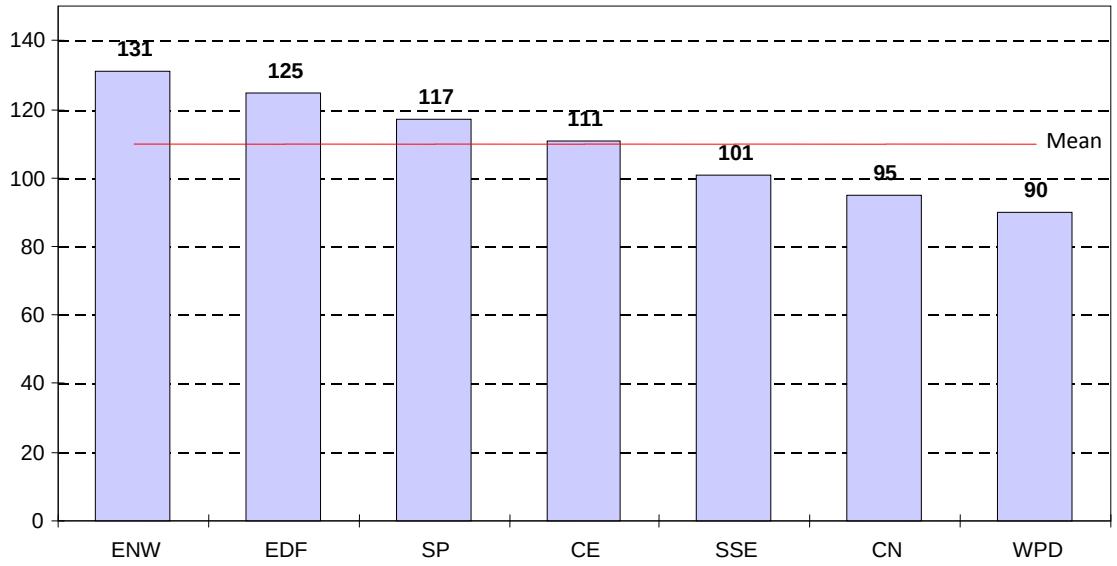
Network Investment 1990 to 2015 (RAV Additions)



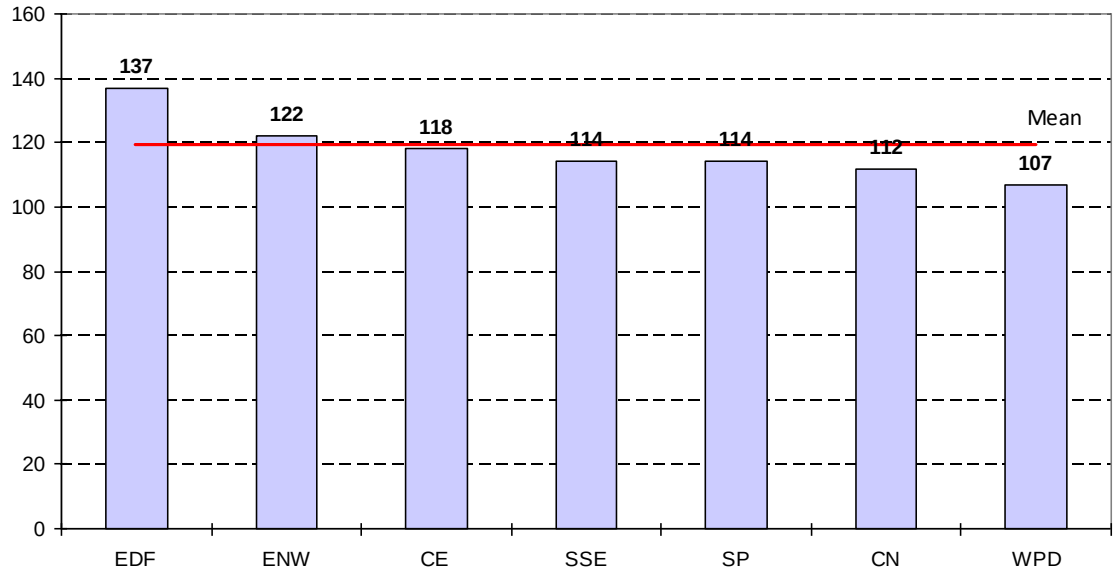
Source: Ofgem draft Financial Model May 2009

The overall position is summarised in the following two bar charts which compare the proposed average fast pot allowance for DPCR5 to allowed operating costs for 2009/10. The second shows the effect of applying DPCR4 capex allocation rules to the same comparison. The detailed spreadsheets behind the charts are included in the attached summary document.

AVERAGE FAST POT ALLOWANCE AS A PERCENTAGE OF 2009/10 RESIDUAL OPERATING COSTS 85/15 SPLIT



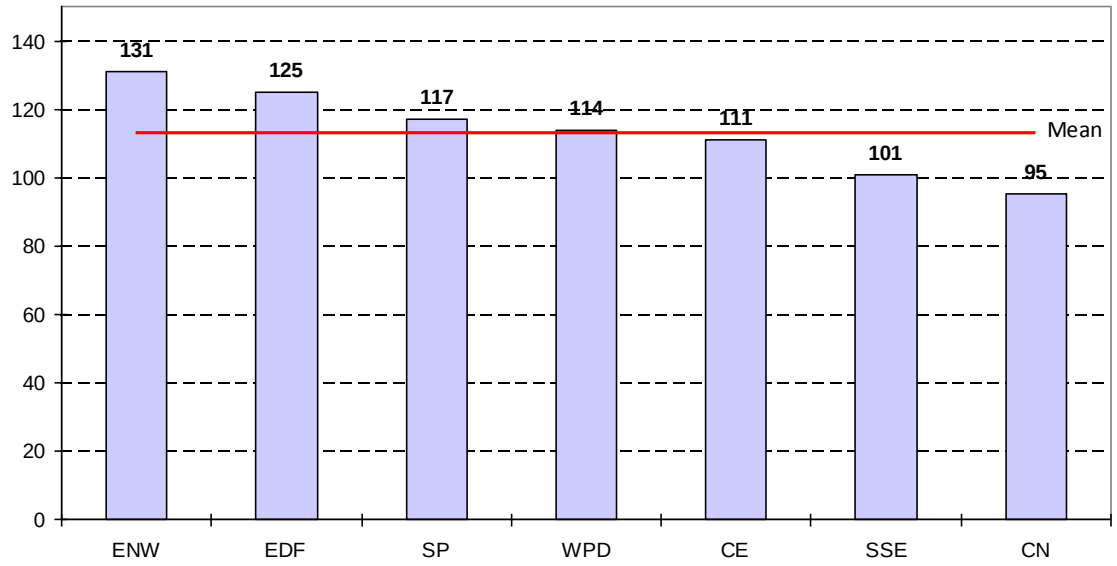
AVERAGE FAST POT ALLOWANCE AS A PERCENTAGE OF 2009/10 RESIDUAL OPERATING COSTS USING DPCR4 ALLOCATION RULES



The combination of these factors leave WPD in a clearly disadvantageous position despite being operating cost efficient, indirect cost efficient, the lowest total IT costs per DNO, lowest capital unit costs, and second to none in all aspects of customer service. The main beneficiary of this analysis is the EDF group. This is not due to carry over from previous review periods as depreciation and return are excluded from the comparisons, but to a series of unjustified operating cost adjustments linked to their higher capex/opex ratio.

In order to recognise the value that WPD has brought to customers across the UK through their capital efficiency and reliability performance the following chart shows the effect of rewarding CML frontier performance as in DPCR4 and adjusting capex unit costs to the median.

AVERAGE FAST POT ALLOWANCE AS A PERCENTAGE OF 2009/10 RESIDUAL OPERATING COSTS 85/15 SPLIT WITH ADDITIONAL CAPEX & REWARDS FOR WPD



The proposed adjustments only achieve an average position for WPD and the company is still left with the toughest reliability targets with the probability of IIS penalties.

We look forward to further constructive discussions with you and your colleagues in order to resolve the outstanding issues between now and the publication of final proposals in November 2009.

Yours sincerely

Alison Sleightholm
Regulatory & Government Affairs Manager