

Summary

The Ofgem Initial Proposals documents describe the overall approach to setting the new price control, the basis for setting allowances, the structure of incentives and the new regulatory arrangements appropriate for the fifth electricity distribution price control review (DPCR5). The Initial Proposals are not complete because they do not cover WACC and the treatment of pension costs and also do not show the results of benchmarking for a significant portion of operating costs.

The main points from our full response are set out in this summary.

Ofgem set allowances in order that an efficient company can cover its forecast costs over a five year period. In the context of setting allowances for DPCR5, Ofgem should consider both operational and capital efficiency together with service delivery.

Ofgem's Initial Proposals are inconsistent and inequitable in that;

Upper quartile performance **is** rewarded for operational cost efficiency

Upper quartile performance is **not** rewarded for capital efficiency and;

Upper quartile performance for service delivery is **not** rewarded

We set out how Ofgem should address this inconsistency in our detailed response by considering each of the three areas below;

Operational Cost Efficiency

There are flaws and errors in Ofgem's detailed workings in relation to operational cost efficiency, although we support the overall approach.

- **Labour and Contractor Rates Normalisation Adjustment**

The normalisation adjustment that has been made for labour and contractor rates is wrong. Engineers and employees operate in a national market and, except for "London Weighting", there is little difference in DNO salaries when compared on a like for like basis. The adjustment unjustifiably favours one of the most inefficient DNO groups, i.e. EDFE.

Ofgem should revert to the labour and contractor rate normalisation adjustment that was proposed in the Initial Results paper, i.e. the adjustment should only apply to EDFE LPN in line with the Gas DPCR.

- **Recognition of Indirect Activity Costs**

DNOs that outsource more of their direct activities will report significantly lower indirect activity costs than those DNOs that insource more of the direct activities. The difference in the levels of outsourcing has not been addressed by Ofgem, with the consequence that the results of the comparative analysis are skewed in favour of DNOs that outsource more of their direct activities.

The exclusion of Alliance Contractors' indirect activity costs from the comparative analysis has no logical basis and results in one DNO's (EDFE)

indirect activity costs to be materially understated. As a result the comparative analysis is wrong.

The alliance contracting adjustment is therefore inequitable because it favours EDFE but penalises DNOs, such as WPD, that manage the delivery of capital projects using in-house staff. The use of “open book” contracts that enable alliance contractors’ indirect activity costs to be recorded as indirect activity costs is entirely correct as it ensures that EDFE report such indirects in a manner consistent with DNOs.

- **Projecting Efficient DPCR4 Costs Forward to DPCR5**

There is a flaw in the detailed calculations that Ofgem use to project forward efficient DPCR4 costs to DPCR5.

The initial proposals use 4 years of data to compare companies. However, in setting allowances for DPCR5 only one year of data is used. The allowances for DPCR5 are therefore skewed by any abnormalities in the final year. It is inconsistent to undertake comparative analysis using four years of data and then use a single year as the starting point for projecting forward. The starting point for projecting forward should be the average efficient costs over the same four year period used for the comparative analysis.

For example: Ofgem’s own analysis, using four years of cost data, has identified that WPD South West is an upper quartile performer in respect of indirect activity cost efficiency. However, as Ofgem’s detailed calculations for projecting forward to DPCR5 are based on the efficient costs for one year only (i.e. 2008/09), some perverse results are produced. Ofgem’s DPCR5 baseline **reduces our** aggregate expenditure from £197m (DPCR4 outturn) to £174m (Table 4.16)

- **Double Counting of Efficiency Savings**

Ofgem have incorrectly interpreted our business plan submission and as a result, double counted our 1% efficiency assumption.

- **Sparsity Adjustment**

We do not understand why Ofgem has decided to make such an adjustment.

At previous price reviews, when operating costs were assessed using drivers based on customer numbers, there were valid arguments for sparsity adjustments. The use of RRP data and the selection of the correct cost drivers, which are predominately asset based, make the need for such adjustments unnecessary.

- **Urbanity Adjustment**

The proposed urbanity adjustment represents 11% of EDFE (LPN)’s annual network operating costs. EDFE also benefit from other significant adjustments for labour and contractor rates which include an element of double-counting. The Initial Proposals do not provide any justification or supporting evidence for these adjustments and they should be removed.

- **Costs Transferred to Network Investment**

Ofgem indicate that certain costs, e.g. an element of both vehicles and transport indirect activity costs and vehicles non operational capital expenditure, have been excluded from the comparative analysis as the costs have been transferred to network investment.

However, it is clear that such costs have not been included in the evaluation of network investment. The efficiency of these costs should be benchmarked.

- **New Costs Arising in DPCR5**

In our FBPQ submissions and the associated commentary we identified some additional activities and specific cost increases that would arise in DPCR5. Ofgem have taken no account of these quantified cost increases. This must be remedied.

- **Data and Modelling Errors**

Detailed in our response.

Capital Cost Efficiency

Whilst operational cost efficiency is rewarded for being above upper quartile, Ofgem have applied no such reward to capital efficiency.

In the context of equalising incentives it is perverse to reward operating cost efficiency when the baseline cost allowances are set but not to reward capital cost efficiency in the same way. Customers benefit more from capital efficiency than from operating cost efficiency because capital costs are the greater part of the total.

It is evident from the unit cost data available from DNOs that both WPD South Wales and WPD South West are the most capital efficient DNOs. If other DNOs' asset replacement unit costs were applied to WPD's asset replacement volumes, then the resulting forecast costs are materially higher than WPD's forecast cost.

Customers throughout the UK benefit from WPD being more capital efficient than other DNOs. If WPD's unit costs were not included in Ofgem's analysis, then the median unit cost values would increase. This would result in an overall forecast increase for other DNOs' asset replacement programme. We estimate that this overall forecast would increase by £100m for DPCR5.

It is inequitable that WPD receives no reward for being capital efficient. WPD should be rewarded for capex efficiency by setting a baseline at upper quartile which feeds into the IQI mechanism.

Service Delivery

On every objective indicator WPD's record of service delivery is second to none;

- Discretionary reward

- Contact Centre Performance
- Guaranteed Standards
- Ombudsman Complaints
- Network Reliability

Reliability is the main determinant of customer satisfaction as well as being the output of network investment and operational efficiency, WPD has outperformed the IIS targets beyond the maximum payout position.

The unplanned CML targets for both WPD South Wales and WPD South West are significantly more demanding than those for any other DNO and unless WPD is rewarded for having more demanding targets DPCR5 will, in effect, reward other companies' poor performance

The unplanned CML targets for both WPD South Wales and WPD South West equate to our average performance in the four year period 2005/06 to 2008/09. Both licensed areas have extensive overhead networks, whilst EDFE (LPN) has a wholly underground network. In absolute terms, the unplanned CML target for WPD (South Wales) is marginally lower than that for EDFE (LPN), whilst the unplanned CML target for WPD South West is marginally higher than that for EDFE (LPN). These targets mean that the average customer in WPD will be off supply for approximately the same length of time as the average customer in London.

In addition, WPD is a frontier performer in respect of unplanned CML. The table below shows the average unplanned CML in the four year period 2005/06 to 2008/09 and each DNO's performance benchmark.

	Average Unplanned CML in Four Year Period 2005/06 to 2008/09	2014/15 Unplanned CML Benchmark	Average Actual as Percentage of Benchmark
CN West	84.3	75.8	111%
CN East	62.3	55.2	113%
ENW	47.8	47.6	100%
CE NEDL	60.3	55.9	108%
CE YEDL	68.7	61.6	111%
WPD S Wales	38.0	55.7	68%
WPD S West	41.9	61.5	68%
EDFE LPN	40.1	40.3	99%
EDFE SPN	86.0	59.4	145%
EDFE EPN	65.4	56.4	116%
SP Distribution	61.2	49.2	124%
SP MANWEB	52.4	48.9	107%
SSE Hydro	59.7	73.3	81%
SSE Southern	63.5	57.3	111%

From the table above it is clear that WPD's performance is better than upper quartile. In other aspects of the Initial Proposals, Ofgem reward upper quartile performance, but have not provided such a reward in respect of unplanned CML.

WPD should be rewarded in two ways.

Firstly, for accepting unplanned CML targets that are more demanding than the targets implied by benchmarking process, WPD should receive rewards that equate to the difference between the benchmark and average performance multiplied by the incentive rate. This would be consistent with the treatment during DPCR4.

Secondly, WPD's frontier performance in respect of supply restoration has revealed what other DNOs could achieve. WPD have had material impact on the unplanned CML targets for other DNOs. Analysis of the data for the four year period 2005/06 to 2007/08 has revealed that, if WPD performance was excluded, the unplanned CML targets for other DNOs would be 7% higher, with the consequence that customers throughout the UK would continue to experience unnecessarily long supply interruptions.

The difference between the currently proposed unplanned CML targets and those derived using an analysis that excludes WPD's performance, multiplied by the incentive rates gives an indication of the economic value WPD bring to the analysis. This value amounts to £38m during DPCR5.

We propose that both WPD South Wales and WPD South West should each be given an additional reward of 1 per cent of revenue per annum in recognition of the economic value that WPD add. This would be consistent with the treatment applied during DPCR4.

Equalisation of Incentives

WPD supports the principle of equalisation of incentives since this attacks the boundary issue between capital and operating costs as that boundary can produce operating cost efficiency through aggressive capitalisation. The proposal to split network operating costs with 85 per cent funded as "slow money" and 15 per cent to be funded as "fast money" is incorrect as it is materially different to treatment at the last price control review.

The overall position is summarised in the following spreadsheets which compare:

- Proposed average fast pot allowance for DPCR5 to allowed operating costs for 2009/10; and
- Effect of applying the DPCR4 cost allocation rules to the average DPCR5 costs.

It is evident that there is a differential impact across DNOs of moving to a uniform 85%/15% split of costs.

For WPD, using DPCR4 rules applied to DPCR5 costs, 74% of IQI eligible costs are funded as slow money.

This ratio must be maintained for DPCR5.

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

	CNW	CNE	ENW	NEDL	YEDL	Wales	West	LPN	SPN	EPN	SPD	SPM	SSEH	SSES	All DNO
2009/10 DPCR4 £m 02/03 prices (Data source DPCR4 Final Proposals)															
Operating Costs (excluding pensions) Row 7 of DPCR4 Final Proposals Tables	66.0	76.2	60.2	46.3	57.9	44.3	55.1	62.9	45.1	88.3	75.7	46.8	50.2	90.7	865.7
Less Reward for Accepting Tough Targets						1.5	0.4								1.9
Less Rates	21.0	25.9	17.5	13.4	19.1	13.1	17.2	21.9	11.6	25.6	32.4	12.8	12.7	35.9	280.1
Less Ofgem Licence Fee	1.1	1.1	1.1	0.7	1.0	0.5	0.7	1.0	1.0	1.6	0.9	0.7	0.3	1.3	13.0
Residual Operating Costs on a Comparable Basis (£m)	43.9	49.2	41.6	32.2	37.8	29.2	36.8	40.0	32.5	61.1	42.4	33.3	37.2	53.5	570.7
Add Reward for QOS Frontier Performance						1.7	1.3								3.0
Add Back Reward for Accepting Tough Targets						1.5	0.4								1.9
Opex Incentive									1.6						1.6
Operating Costs for Comparison (£m at 2002/03 Prices)	43.9	49.2	41.6	32.2	37.8	32.4	38.5	40.0	34.1	61.1	42.4	33.3	37.2	53.5	577.2
2009/10 DPCR4 Operating Costs for Comparison (£m 2007/08 Prices)	51.6	57.8	48.9	37.8	44.4	38.1	45.2	47.0	40.1	71.8	49.8	39.1	43.7	62.9	678.2
Average Year During DPCR5 (£m at 2007/08 Prices) (Data Source DPCR5 Initial Proposals)															
Fast Pot	51.6	52.0	64.1	40.1	50.8	32.1	42.5	58.5	59.7	79.9	48.5	55.8	34.8	72.8	743.2
2010/11 DPCR5 Fast Pot as Percentage of 2009/10 DPCR4 Residual Operating Costs	100%	90%	131%	106%	114%	84%	94%	124%	149%	111%	97%	143%	80%	116%	110%
	95%		131%		111%		90%		125%		117%		101%		110%

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

	CNW	CNE	ENW	NEDL	YEDL	Wales	West	LPN	SPN	EPN	SPD	SPM	SSEH	SSES	All DNO
2009/10 DPCR4 £m 02/03 prices (Data source DPCR4 Final Proposals)															
2009/10 DPCR4 Operating Costs for Comparison (£m 2007/08 Prices)	51.6	57.8	48.9	37.8	44.4	38.1	45.2	47.0	40.1	71.8	49.8	39.1	43.7	62.9	678.2
DPCR5 Average (£m at 2007/08 Prices) Slow Pot & Fast Pot Determined Using DPCR4 Methodology Funded as Opex	59.7	63.2	59.8	40.6	56.1	37.2	52.1	59.7	60.9	96.4	48.8	52.7	36.8	84.3	808.2
2010/11 DPCR5 Fast Pot as Percentage of 2009/10 DPCR4 Residual Operating Costs	116%	109%	122%	107%	126%	98%	115%	127%	152%	134%	98%	135%	84%	134%	119%
	112%		122%		118%		107%		137%		114%		114%		119%

The Effect of Proposed Changes

We cannot model all the effects of the changes proposed but can show the effect of rewarding network performance in line with DPCR4 and capital efficiency using the same logical basis as operational cost efficiency. The following spreadsheet details these changes to WPD's position with regard to fast money.

If these changes are not made WPD's reward for frontier network performance is IIS penalty and its reward for frontier capital efficiency is limited by its ability to reduce unit costs further and be rewarded under IQI.

The messaging sent by not recognising these two important areas of performance is clear. WPD should not have outperformed the boundary limits of IIS in DPCR4 and submitted inflated capital unit costs.

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

	CNW	CNE	ENW	NEDL	YEDL	Wales	West	LPN	SPN	EPN	SPD	SPM	SSEH	SSES	All DNO
2009/10 DPCR4 £m 02/03 prices (Data source DPCR4 Final Proposals)															
2009/10 DPCR4 Operating Costs for Comparison (£m 2007/08 Prices)	51.6	57.8	48.9	37.8	44.4	38.1	45.2	47.0	40.1	71.8	49.8	39.1	43.7	62.9	678.2
Average Year During DPCR5 (£m at 2007/08 Prices) (Data Source DPCR5 Initial Proposals)															
Current Fast Pot	51.6	52.0	64.1	40.1	50.8	32.1	42.5	58.5	59.7	79.9	48.5	55.8	34.8	72.8	743.2
18% of Additional Asset Replacement						1.1	1.6								2.7
Reward for QOS Frontier Performance (1%)						1.9	2.4								4.3
Reward for Accepting Tough Targets						5.3	8.2								13.5
Adjusted Fast Pot	51.6	52.0	64.1	40.1	50.8	40.4	54.7	58.5	59.7	79.9	48.5	55.8	34.8	72.8	763.7
2010/11 DPCR5 Adjusted Fast Pot as Percentage of 2009/10 DPCR4 Residual Operating Costs	100%	90%	131%	106%	114%	106%	121%	124%	149%	111%	97%	143%	80%	116%	113%
	95%		131%		111%		114%		125%		117%		101%		113%