Initial Proposals

Chapter 2 – Behaviours, Incentives, Funds and Obligations

Question 1: Have we introduced a set of measures that can be understood by customers and other stakeholders?

Yes.

Question 2: Are we aiming to encourage the behaviour you consider appropriate for DNOs in the 2010 to 2015 period?

The behaviours identified under the three themes of Environment, Networks and Customers are correct.

To ensure the correct behaviours are encouraged Ofgem need to consider the following.

Environment

Ofgem must support initiatives that will help deliver the low carbon economy and in doing so distinguish between projects that can deliver real customer benefits in the short/medium term over theoretical proposals that may never be implemented. Our smart networks trial has been exceptionally successful as it concentrates on the basic principle that any development of an active network initially requires real time measurement of voltage and current. In our detailed business case submitted to Ofgem we show that the enabling of smart grids is achievable across our entire network using existing specification metering equipment at a reasonable cost.

Networks

Ofgem set allowances in order that an efficient company can cover its forecast costs over a five year period. In this context, efficiency has three main considerations:

- Operational Costs
- Capital Costs
- Service Delivery

Ofgem's Initial Proposals are inconsistent and inequitable in that they reward upper quartile performance in respect of operational cost efficiency but ignore upper quartile performance in respect of capital efficiency and service delivery. We set out in detail in Chapter 3 of this response how this should be addressed.

Customers

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 driver of customer satisfaction and results from network investment and operational efficiency. WPD has outperformed the IIS targets beyond the maximum payout position. In absolute terms, the unplanned CML target for WPD South Wales is lower than that for EDFE (LPN), whilst the unplanned CML target for WPD South West is only marginally higher. 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. The CML targets for both WPD South West and WPD South Wales are approximately 65% of their benchmark value. In contrast, with the exception of LPN no other company is even at their specific benchmark and all other DNOs are on a glide path toward it. In summary WPD is at least 35% better than the position the other companies (except LPN) should reach in 2015.

The current proposal effectively leaves WPD exposed to penalties under IIS, with little of any prospect of IIS rewards.

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. We set out in Chapter 14 of this response how this should be rectified.

Question 3: Are the proposed mechanisms likely to be successful?

Subject to the principles described above being adopted, yes. We also have the following specific comments;

Ofgem should ensure that the mechanisms associated with the incentives, funds and obligations are not over-complicated with burdensome reporting requirements. In particular, the proposals in relation to connections standards and reporting should be simplified.

The principle of equalising incentives is correct although we set out later in this response why the proposed 85%/15% split is incorrect. 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. As stated in our response to Question 2 it therefore does not seem logical to reward operating efficiency without assessing capital efficiency as the latter accounts for approximately 70% of expenditure.

We make specific comments on the RORE and IQI mechanisms later in this response.

Chapter 3 – Proposed allowed revenues

Question 1: Have we taken an appropriate approach to setting allowed revenues?

Ofgem's Initial Proposals fail to set allowed revenues that recognise both operating and capital efficiency. They also do not recognise WPD's outstanding service delivery. Ofgem need to consider each of these factors when setting DPCR5 allowances. As described below, the benefit of WPD's capital and service efficiency contributes £138m in total to the overall DPCR5 forecasts and this should be recognised at Final Proposals.

The four components of the price control to be considered in the round are:

- Funding of Operational Costs (Fast Pot)
- Operational Cost Efficiency and Allowance Setting
- Network Investment Efficiency and Allowance Setting
- Service Delivery

Funding of Operational Costs (Fast Pot)

Ofgem's proposal that all DNO's "baseline costs within the IQI mechanism" should be allocated to slow pot/fast pot on an 85%/15% split is fundamentally flawed. The approach rewards high cost, poorly performing DNOs with a lower risk settlement by allowing more of their costs to be allocated to the fast pot. This is due to three inter-related issues.

1. The normalisation adjustments that Ofgem have undertaken prior to the comparative analysis have favoured the high cost DNOs.

2. The use of a uniform 85%/15% split disadvantages DNOs with higher percentages of network operating costs and indirect activity cost, i.e. the smaller DNOs.

   The table below compares:

   - Allowed operating cost for 2009/10; and
   - Average allowed fast post cost for DPCR5.

Comparison of Allowed Costs for 2009/10 and DPCR5 (£m at 2007/08 Prices)					
	Allowed Operating Costs for 2009/10 (£m)	Average Allowed Fast Pot Costs for DPCR5 (£m)	Increase (£m)	DPCR5 as Percentage of 2009/10	
CN West	51.6	51.6	0.0	100%	95%
CN East	57.8	52.0	(5.8)	90%	
ENW	48.9	64.1	15.2	131%	131%
CE NEDL	37.8	40.1	2.3	106%	111%
CE YEDL	44.4	50.8	6.4	114%	
WPD (South Wales)	38.1	32.1	(6.0)	84%	90%
WPD (South West)	45.2	42.5	(2.7)	94%	
EDF (LPN)	47.0	58.5	11.5	124%	125%
EDF (SPN)	40.1	59.7	19.6	149%	
EDF (EPN)	71.8	79.9	8.1	111%	
SP Distribution	49.8	48.5	(1.3)	97%	117%
SP MANWEB	39.1	55.8	16.7	143%	
SSE Hydro	43.7	34.8	(8.9)	80%	101%
SSE Southern	62.9	72.8	9.9	116%	
All DNO	678.2	743.2	65.0	110%	110%

From the table above it is evident that Ofgem's proposed 85%/15% split produces materially different impacts on DNOs.

The reason why the proposed 85%/15% split produces materially different impacts is that the composition of "baseline costs within the IQI mechanism" is not uniform across DNOs. In addition, the costs "outside the IQI and not facing equalised incentives" are not uniform across DNOs.

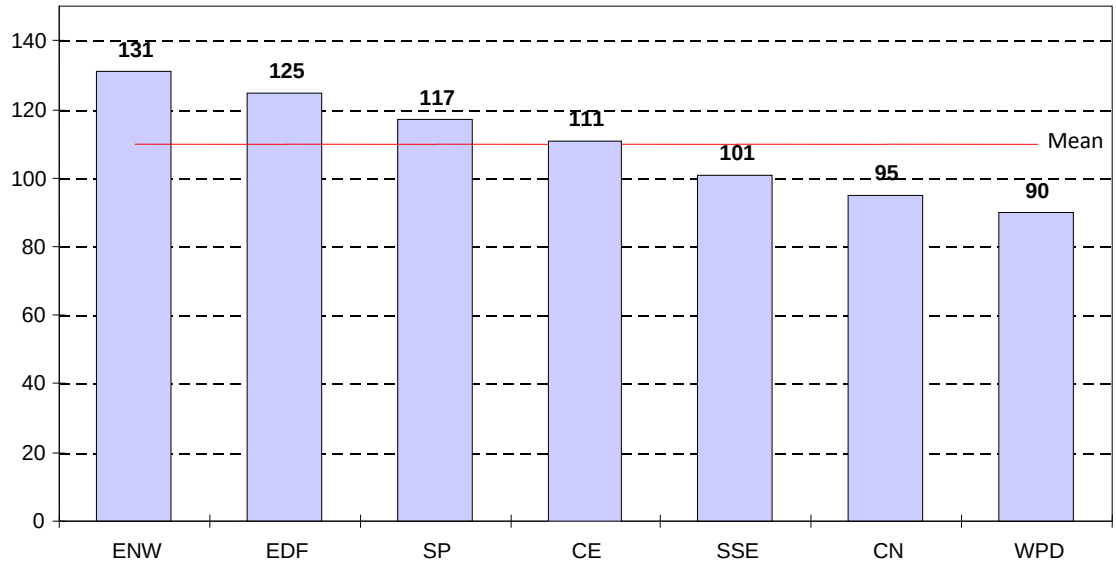
For WPD, the application of the rules developed for DPCR4, when applied to the DPCR5 costs, result in a 74%/26% split of "baseline costs within the IQI mechanism". This percentage split should be used for WPD in DPCR5.

The following two charts show the:

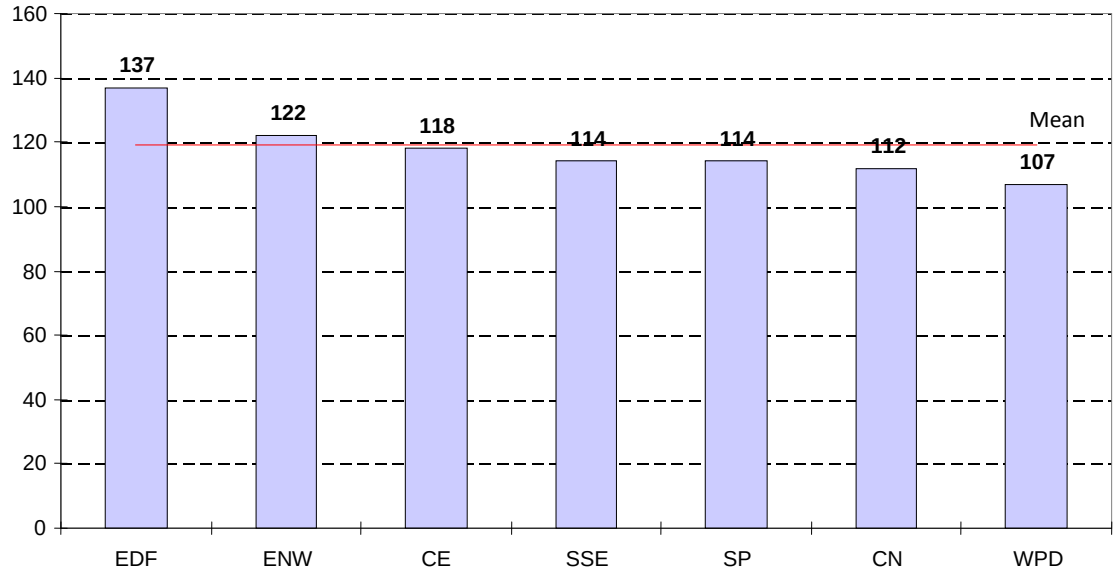
- Proposed average fast pot allowance for DPCR5 to allowed operating costs for 2009/10; and
- Effect of applying the DPCR4 cost allocation rules to the average DPCR5 costs.

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

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



3. Ofgem's Initial Proposals, in respect of rewarding efficiency, are inconsistent and inequitable. Ofgem have:

- Rewarded upper quartile operational cost efficiency;
- Failed to reward capital cost efficiency; and
- Failed to reward upper quartile service delivery.

The combined effect of these three issues lead to DNOs who are good performers and efficient receiving less fast pot money in DPCR5 than in DPCR4 and DNOs who

are poor performers and less efficient to receive more fast pot money in DPCR5 than in DPCR4.

For WPD, this inequitable treatment can be remedied by:

- Using a 74%/26% split of "baseline costs within the IQI mechanism";
- Rewarding capital efficiency; and
- Rewarding upper quartile service delivery performance.

Operational Cost Efficiency and Allowance Setting

There are flaws and errors in Ofgem's detailed workings. These flaws and errors are identified below;

1. Labour and Contractor Rates Normalisation Adjustment

   The normalisation adjustment that has been made for labour and contractor rates is wrong. The adjustment is without rational justification and favours one of the most inefficient DNO groups, i.e. EDFE.

   It is clear that Ofgem have changed the methodology for determining the labour and contractor rates normalisation since the paper published in May 2009. In the May paper, Ofgem indicated that the labour and contractor rates normalisation adjustment for EDFE (LPN) was £7.2m. In the Initial Proposals it is indicated that the proposed normalisation adjustment for EDFE (LPN) has more than doubled to £15.0m, whilst favourable adjustments of £4.0m and £3.0m have been introduced for EDFE (SPN) and EDFE (EPN) respectively.

   WPD has demonstrated that:

   - 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 Office of National Statistics data used in the model promoted by EDFE is not sufficiently disaggregated. This favours EDFE as the right level would confirm that there is no difference in DNO salaries.
   - Larger contractors are bidding for contracts in a national market, with the consequence that, with the exception of London weighting, there is no difference in comparable contractors' rates across UK. The existence of a national market for contractors can be verified by reference to the JIB rates, which apply to 40,000 employees in the electrical contracting industry. These are national rates which are uplifted in London by 12%.

   Other DNOs have advised Ofgem of other problems with the model promoted by 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.

2. 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. This is particularly evident in the case of CN East who outsource more direct activities than other DNOs with the result that they are identified as better than upper quartile efficiency for indirect activities but are one of the least capital efficient DNOs.

The "alliance contracting" adjustment is inequitable as it favours EDFE but penalises DNOs, such as WPD, who 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 such as WPD. The exclusion of alliance contractors' indirect activity costs from the comparative analysis has no logical basis and results in EDFE's indirect activity costs being materially understated. It would be just as logical to exclude some of WPD indirect activity costs from the comparative analysis.

The fundamental problem is that the different of levels of outsourcing have not been normalised. In order to facilitate DNOs providing Ofgem with the data required to undertake this normalisation, WPD and ENW have jointly prepared reporting templates, definitions and guidance that have been distributed to all DNOs.

In addition, WPD has developed a methodology for normalising the level of outsourcing and rebalancing the indirect activity costs that are embedded in contractors costs. The key to the rebalancing of the indirect activity costs that are embedded in contractors' costs is the identification of the indirect activity cost recovery rate used by contractors. One of WPD's major contractors, who undertake our trench excavation, cable laying and reinstatement works, has provided us with a breakdown of their costs. This contractor, which operates throughout the UK, indicates that the indirect activity cost recovery rate embedded in their charges is 22%. WPD propose that this 22% indirect activity cost recovery rate should be used to determine the indirect activity costs embedded in **all** contractors' costs. The use of the 22% recovery rate will result in a conservative value of the indirect activity costs embedded in contractors' costs, as the nature of works undertaken by the "dig & lay" contractor is essentially a substitute for DNO own labour. The indirect activity cost recovery rate for contractors that undertake work that has a wider scope; e.g. project management and engineering design; would clearly be higher.

The following table uses data from Table 2.2 of each DNO's 2008/09 RRP and illustrates the adjustment required to each DNOs' indirect activity costs to normalise for the different levels of outsourcing. Clearly it would be necessary to undertake the normalisation for each year's data.

INSOURCING/OUTSOURCING ADJUSTMENT
(Data Source Table 2.2 2008/09 RRPs)

	Total Direct Costs (£m)	Total Direct Contractor Cost (£m)	Percentage Contractors	Indirect Costs Embedded in Actual Contractors Costs (£m)	Normalised Contractor cost (i.e. if average outsourced) (£m)	Indirect Costs Embedded in Normalised Contractors Costs (£m)	Adjustment to Indirect Costs Required to Normalise For Difference in Contractor Usage[(1)] (£m)
CN West	183.1	110.5	60%	24.3	105.3	23.2	1.2
CN East	203.7	148.9	73%	32.8	117.1	25.8	7.0
ENW	157.8	84.1	53%	18.5	90.7	20.0	-1.5
CE NEDL	117.9	79.0	67%	17.4	67.8	14.9	2.5
CE YEDL	156.8	107.7	69%	23.7	90.1	19.8	3.9
WPD Wales	72.1	31.6	44%	7.0	41.4	9.1	-2.2
WPD West	118.9	47.4	40%	10.4	68.4	15.0	-4.6
EDF LPN	188.2	112.8	60%	24.8	108.2	23.8	1.0
EDF SPN	195.4	120.2	62%	26.4	112.3	24.7	1.7
EDF EPN	308.4	189.9	62%	41.8	177.3	39.0	2.8
SP Dist	144.9	87.6	60%	19.3	83.3	18.3	0.9
SP Manweb	158.9	94.2	59%	20.7	91.3	20.1	0.6
SSE Hydro	81.7	18.1	22%	4.0	47.0	10.3	-6.4
SSE Southern	225.1	102.9	46%	22.6	129.4	28.5	-5.8
TOTAL	2129.8	1224.4	57%	269.4	1224.4	269.4	0.0

Note (1) Positive values indicate an increase in indirect activity costs, negative number indicate a decrease in indirect activity costs

3. Projecting Efficient DPCR4 Costs Forward to DPCR5

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

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. For WPD South West, the forward projections are that:

- Indirect activities are to be **reduced** from £197m in DPCR4 to £174m in DPCR5 (as shown in Table 4.16 of Ofgem's document referenced 94/09); and
- Non operational capital to be **reduced** from £48m in DPCR4 to £41m in DPCR5 (as shown in Table 4.17 of Ofgem's document referenced 94/09).

Indirect activity costs within the scope of the price control are volatile year-on-year as they are impacted on by a range of factors such as the level of:

- New connections activity;
- Excluded services activity;
- Insurance claims; and
- Captive insurer margins.

It is illogical to undertake comparative analysis using four years 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.

4. Double Counting of Efficiency Savings

In commentary associated with the February 2009 FBPQ, we stated that:

> "The vast majority of WPD staff are on incremental salaries. Consequently, all other factors remaining unchanged, WPD labour costs would increase by up to 1% each year. However, in order to offset this annual increase in costs, all the WPD labour costs in the FBPQs assume up to a1% productivity improvements each year.
>
> It has not been necessary to include this productivity improvement in Table C1".

Ofgem have applied a 1% year-on-year efficiency saving in their forward projects and state that WPD "have assumed a 1% per year efficiency improvement as part of their business plan submission". Ofgem's incorrect interpretation essentially represents a double counting of our efficiency assumption as Ofgem have not taken into account the associated offsetting annual increase in costs.

5. 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.

6. 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. We do not understand why so many significant adjustments are necessary for EDFE and Initial Proposals do not provide any justification or supporting evidence.

7. 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. This must be remedied.

8. 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.

The quantified increases included in our FBPQ and associated commentary are shown in the table below.

Average Annual New Costs Arising During DPCR4 (£m)		
	WPD (South Wales)	WPD (South West)
Indirect Activity Costs		
Tax Changes associated with car scheme	0.26	0.28
Correction of stores rounding error in 2007/08	0.20	0.00
Provision of web based data to distributed generators	0.10	0.10
IIS telephony and broader customer satisfaction surveys	0.10	0.10
True up of stores pricing differences	0.10	0.00
True up of captive insurer margin	0.20	0.20
Wayleave payments	0.40	0.90
Communication costs associated with enhanced ENMAC and ENMAC Mobile functionality	0.80	0.80
Inspection and Maintenance		
Increased tower inspection	0.10	0.20
Increased pole inspection	0.30	0.40

The increased pole inspection was not included in Version 3.0 of our FBPQ. It has been added to Version 3.1 of our FBPQ as a consequence of the HSE determining that our inspection cycle associated with aged poles, i.e. 10 years, is too long. The increased pole inspection cost reflects a move to a weighted average pole inspection cycle of 7 years.

9. Data and Modelling Errors

We have identified two significant data and modelling errors.

9.1 On Row 55 of FBPQ Table T0, i.e. Inspections and Maintenance, the formulae incorrectly subtracts the cost of Remote Location Generation from the Inspections and Maintenance Costs (NOC1). This is incorrect as the costs of Remote Location Generation arte not included in the Inspections and Maintenance cost shown in Table NOC1;

9.2 The comparative analysis of fault costs has been limited to LV & HV overhead line faults and LV & HV underground cable faults. This means that a significant number of LV & HV faults, (relating to switchgear, transformers and other assets) and the associated costs are excluded from the analysis. The effect of excluding these faults from the comparative analysis is not equal across DNOs as there are reporting differences across DNOs. Therefore, the comparative

analysis undertaken has not revealed relative efficiencies but has highlighted reporting difference.

The table below summarises data from each DNOs MTP submissions for 2008/09 and shows the total number of LV & HV faults excluding exceptional events. From the table it is evident that:

- For LV network faults, the percentage of faults excluded per DNO from Ofgem's comparative analysis ranges from 1% to 33%;
- For HV network faults, the percentage of faults excluded per DNO from Ofgem's comparative analysis ranges from 20% to 48%.

NUMBER OF LV & HV FAULTS DURING 2008/09 (Excluding Exceptional Events)															
	CN West	CN East	ENW	CE NEDL	CE YEDL	WPD Wales	WPD West	EDF LPN	EDF SPN	EDF EPN	SP Dist	SP Manweb	SSE Hydro	SSE Southern	All DNO
Service OH	915	816	815	1007	362	1324	2257	0	771	1960	639	1066	439	532	12903
Service UG	2588	2765	3046	1995	5485	1097	1754	2912	2372	4237	1845	1949	1241	3481	36767
LV OH	1013	846	693	234	206	661	1640	0	875	1771	878	1268	903	2162	13150
LV UG	2421	3639	6193	2366	4435	928	2328	4388	3306	7678	4497	2666	1636	12492	58973
LV Switchgear	36	482	223	336	394	1122	3282	232	308	678	385	237	245	95	8055
LV Other	2875	3415	19	2440	4286	89	120	26	90	96	17	4	129	72	13678
LV Total	9848	11963	10989	8378	15168	5221	11381	7558	7722	16420	8261	7190	4593	18834	143526
Faults Excluded From Ofgem's Comparative Analysis	2911	3897	242	2776	4680	1211	3402	258	398	774	402	241	374	167	21733
	30%	33%	2%	33%	31%	23%	30%	3%	5%	5%	5%	3%	8%	1%	15%
HV OH	1107	798	951	579	603	747	1326	0	697	857	1170	1231	1270	1056	12392
HV UG	686	289	646	459	623	423	390	427	771	990	653	445	244	814	7860
HV Switchgear	261	375	424	230	234	254	421	58	372	579	475	572	313	527	5095
HV Other	503	67	149	183	66	145	178	89	293	1113	249	274	89	60	3458
HV Total	2557	1529	2170	1451	1526	1569	2315	574	2133	3539	2547	2522	1916	2457	28805
Faults Excluded From Ofgem's Comparative Analysis	764	442	573	413	300	399	599	147	665	1692	724	846	402	587	8553
	30%	29%	26%	28%	20%	25%	26%	26%	31%	48%	28%	34%	21%	24%	30%
Overall Total	12405	13492	13159	9829	16694	6790	13696	8132	9855	19959	10808	9712	6509	21291	172331
Faults Excluded From Ofgem's Comparative Analysis	3675	4339	815	3189	4980	1610	4001	405	1063	2466	1126	1087	776	754	30286
	30%	32%	6%	32%	30%	24%	29%	5%	11%	12%	10%	11%	12%	4%	18%

The differences in the percentage levels of faults excluded are due to reporting differences. For example, consider a non damage LV fuse failure at an HV/LV substation, within WPD this "fault" would be classified as "LV switchgear", whereas with SSE it would be classified as either LV overhead line or LV underground cable. To address the current inequitable exclusion of faults, it is necessary to allocate the faults currently excluded, and their associated costs, to either LV & HV overhead line faults or LV & HV underground cable faults. Our proposed approach for this reallocation is outline below.

LV Switchgear Faults	Allocate 100% to LV underground cable
LV Other Faults	Allocate 100% to LV underground cable
HV Switchgear Faults	Allocate ground mounted switchgear fault as underground cable Allocate pole mounted switchgear faults as overheads line
HV Other Faults	Allocate using proportion of known faults

Network Investment Efficiency and Allowance Setting

There are flaws and errors in Ofgem's detailed workings in assessing DNOs network investment proposals. These flaws and errors are as follows:

1. Capital Efficiency

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

   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 (approximately 80% higher when Central Networks unit costs were used). Closer examination of other DNOs' unit costs indicates, for example, that Central Networks are purchasing unnecessarily expensive plant such as 33 kV GIS switchgear.

   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 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.

2. Network Investment

Ofgem's proposed reduction to WPD's network investment forecast is summarised below. These reductions are not acceptable and we will need to meet with Ofgem to discuss which requirements cannot be met (licence condition, outputs etc.) as a result of this shortfall in costs.

South Wales	South West
£1.6m reduction in reinforcement	£4.3m reduction in injurious affection
£4.0m reduction in asset replacement due to unit costs	£7.8m reduction in asset replacement due to unit costs
£2.8m reduction in ESQCR due to unit costs	£8.3m reduction in ESQCR due to unit costs
£3.6m reduction in substation security	
£1.8m reduction in Operational IT & Telecomms	£1.8m reduction in Operational IT & Telecomms
£2.6m reduction in Substation Flood Defences	£0.7m reduction in Substation Flood Defences
£0.8m QOS IIS completely eliminated	
£8.5m Technical losses completely eliminated	£11.8m Technical losses completely eliminated

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

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 service delivery.

Question 2: What assumptions do you think we should use for real price effects on DNOs over the 2010-2015 period?

Ofgem's view that ongoing efficiency improvements of around 1% per annum should be achievable across all DNOs is correct and consistent with the level we have built into our FBPQ.

We set out our detailed assumptions for real price effects over the period 2010–2015 in each of our FBPQ submissions. Our assumptions were based on work carried out on our behalf by First Economics and we provided a report to Ofgem "The rate of frontier shift affecting electricity DNOs" to support our initial business plan submission in July 2008. This work was updated in December 2008 and again in May 2009 to support subsequent FBPQ submissions and reflect changes in the economic climate.

We set out in our response to the May methodology update why we believe this work is robust and First Economics met with Ofgem's consultants CEPA to discuss areas of difference with their work. We also provided further evidence to demonstrate that CEPA's contention that electricity industry labour costs will increase more slowly than average earnings in the period to 2015 is incorrect.

Our view on RPEs, which we set out in the May 2009 document, referenced above is that:

- Opex RPEs will be 4.1% in the current year and 0.8% between 2010/11 and 2014/15.
- Capex RPEs will be 2.9% in the current year and 1.7% between 2010/11 and 2014/15.

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

Question 3: What are your views on PwC's range for WACC?

PwC's range for WACC is very wide ranging from 3.0% to 4.85% in post-tax real terms.

Risk Free Rate (RFR)

PwC note the difficulties associated with using ILG's as a basis for calculating the RFR. However, they reject the use of the swap market to determine the RFR instead because they regard it as volatile as a result of credit default pricing and other technical matters. Notwithstanding the acknowledged distortions from using ILGs which depress the RFR, PwC use a range of 1.9% to 2.5% for the RFR. We agree with PwC that 2.5% is the value consistently used in regulatory determinations since 2000 and would argue that the lower rates derived from ILGs are depressed by excess demand for ILG's in the market.

Credit Spreads

PwC use a 10 year average credit spread – a period that includes record low credit spreads over a number of years. This is unrealistic as a forecast because it is very unlikely that such low credit spreads will be available for the foreseeable future. Current indications for WPD show credit spreads in the range 200BP to 300BP and although this may reflect market uncertainty that may not continue forever, to use a credit spread below 200BP would in effect lock most DNOs out of the debt capital markets for DPCR5 thereby leaving them unable to effectively finance their operations for the longer durations that the asset lives require, i.e. it would significantly increase DNOs financing and refinancing risk.

Pretax Cost of Debt

Taking the two points above together, a real pretax cost of debt below 4.5% (i.e. 2.5% RFR plus 2.0% credit spread) would leave DNOs with difficulties in raising sufficient funds to finance their operations without taking on considerable refinancing risk.

Question 4: Do you think we need a mechanism to address cost of debt uncertainty?

No. DNOs have good access to capital markets and bank funding and as such have been encouraged by Ofgem to regard the cost of capital as part of incentive regulation. Therefore, provided that the cost of capital has not been set aggressively, there is no need for further protection against financial market volatility (in the same way that there is no protection within capex for commodity market volatility).

Ofgem should continue with its current approach on the cost of debt without the introduction of debt reopeners or a trigger mechanism.

Question 5: What are your views on the debt trigger mechanism?

See response to Question 4. A debt trigger mechanism is unnecessary.

Chapter 4 – Risk and Rewards

Question 1: Do you agree with our approach to calibrating the price control settlement?

There is insufficient information in Initial Proposals to understand how the RORE mechanism will operate in practice, although we support the mechanism in principle.

The current proposed weighting between the “customer” and “environment” incentives within the mechanism are incorrect. Customers’ priorities are the performance of the network and the response they receive when they contact a DNO. Our own research shows these specific measures are ranked more highly over priorities relating to the environment where customers’ requirements are more aspirational. This is confirmed by Ofgem’s latest research where although customers state that they rank the environment highly and are largely supportive of investments in network technologies

and improvements to serve a possible future low carbon economy, when asked to choose between the green option of being off supply for a few hours in the event of an outage or a generator being used, the majority opt for the generator.

The calibration currently proposed within the RORE mechanism should therefore be reversed with the greater priority given to the customer measures over the environment ones.

Question 2: Do you think DNOs should be awarded a low baseline WACC and be given opportunities to earn more through outperformance or a higher WACC with more limited opportunities to earn through outperformance?

The baseline WACC should be determined based on the cost in the debt and equity markets. DNOs that out-perform, provided that out-performance is correctly determined and calibrated, should earn above the baseline WACC and for DNOs that under-perform vice-versa. This outperformance should come from other incentives and rewards and not necessarily from an additional RORE/WACC incentive. Certaintity over what the WACC is provides the foundation for the low cost of capital available from the markets. A WACC that is only known ex post facto may not be secure enough to maintain a low cost capital in the markets

Question 3: What comments do you have on our early views on how different incentives should be calibrated and the impact on customers' bills?

See response to Question 1 above.

Question 4: Do you agree with our proposed mechanisms for handling uncertainty?

Yes. The proposals are broadly similar with DPCR4 and maintain the same level of risk.

Incentives and Obligations

Chapter 1: Low carbon networks fund

Question 1: Do you agree with our proposals for a new mechanism to encourage DNOs to develop their role in the low carbon economy?

Yes.

Question 2: In particular, do you agree with:
- The proposed size of the funding?
- The proposals for discretionary rewards?
- The two tier structure?
- The proposals to recover tier 2 costs over a five year period?
- The measures to mitigate DNO risk?

We agree that the size of the fund is appropriate and that flexibility via the use of discretionary rewards is necessary due to the uncertain nature of the likely projects. The two tier approach is a practical method to allow smaller scale trials to be carried out without a significant administrative burden. We agree that the costs of large scale trials of this type should be recovered as they are incurred. The proposal creates a framework within which we would seek to progress our smart network metering proposal.

Question 3: Do you think we have adequately balanced the DNOs and customer risk?

Yes.

Question 4: Do you agree that DNOs should be allowed to use any benefits accrued from the project to cover their contribution (minimum 10 %) to the project funding, or should the direct benefits be subtracted from the project cost before the DNO contribution is calculated, so that the DNO always contributes at least 10 % of the project cost?

For innovative projects that are likely to produce benefits across the whole supply chain, this is a pragmatic solution.

Question 5: Do you agree that the funding should be provided on a use it or lose it basis, and should the tier 2 funding be revamped over the period?

Yes.

Question 6: Do you consider that this mechanism will achieve our stated objectives?

Yes, we will be seeking to progress our smart network metering proposal via this mechanism.

Chapter 2: Provision of Information to Distributed Generation

Question 1: Have we correctly captured the customer's information needs?

Yes.

Question 2: Do you agree with the scope of proposed licence obligations?

Yes.

Question 3: Do you agree with our proposal to request DNOs to commit to a strategy for information provision?

Yes, this will enable us to fit any additional information in with the way we deal with requests for connection.

Chapter 3: Distributed generation incentive framework

Question 1: Do you agree with our proposal to retain the DG incentive framework largely unchanged from DPCR4, and do you have any comments on the detail of our proposals?

Given the significant uncertainty in the volume of generation likely to connect the existing framework is appropriate.

We agree that UoS should be recovered from a single combined demand and generation pot of required revenue. We have already shared the detail of how we propose to do this from April 2010 and await your comments.

Chapter 4: Use of system charging to pre-2005 connected Distributed Generation

Question 1: Do you agree with our proposal to terminate the blanket exemption from use of system charges for pre-2005 connected DG, with effect from 1 April 2010?

We agree with the principle that all generators should pay UoS charges. The issue is how and over what timeframe to achieve this.

As the expectation at the time most pre-2005 generators connected was that they would never pay GDUoS charges, it is not surprising that much of the documentation is unclear on payment or otherwise for access rights and the time period that these exist for. Seeking to enforce change to these commercial contracts as proposed will be a significant task.

The December policy paper proposal was to mandate DNOs to develop revised arrangements for charging all DG on the same basis by 2012. Bringing this date forward to April 2010 is impractical if decisions on the need for and methods of calculating compensation for pre-2005 generators are not being considered until the time of final proposals.

The pragmatic solution is to retain an exemption from GDUoS charges for pre-2005 connected DG a fixed period of time to reflect the likely life of generation projects. This is typically 15 years and hence an exemption to 2020 would be appropriate.

The information request that Ofgem made about the connection terms of pre-2005 generators covered those greater than 5MW. These represent around 20% of pre-2005 generators where greater historic information is available. A significant amount of resource will be used to implement these proposals that would be better used assisting further generation connections.

We agree that new standardised contracts as part of DCUSA are the best way forward the issue is how to migrate all existing connections onto these. If the exemption is extended then this migration is not necessary.

Chapter 5: Transmission exit charges incentive

Question 1: Do you agree with the proposed hybrid approach for the regulatory treatment of transmission exit charges?

We do not agree that an incentive on transmission grid exit charges is required or that there is evidence that distribution networks have been developed uneconomically to take advantage of the current arrangements.

If an incentive is to be introduced then the proposal is a better balance than one which incentivises all exit charges. It is important that the incentive is based on cost rather than capacity as a DNO should not be penalised for expansion of exit capacity entirely funded by a party connecting to the distribution or transmission system where this is the most economic solution.

Should such an incentive be introduced, it will need changes to Connection and Use of System Code (CUSC) to allow much greater scrutiny of National Grid outturn costs on their works and greater ability to challenge these.

Question 2: Do you agree that in setting the scope of the incentive we targeted the appropriate cost items?

We agree that if an incentive is required then it is appropriate to only target expansion requirements that are not recovered directly from connecting parties.

Question 3: Do you agree with the level of exposure under the proposed sharing factor?

If an incentive is required then the sharing factor is appropriate.

Chapter 6: Losses incentive

Question 1: Do you agree with our proposal to provide explicit funding for justified low loss investments to provide direct recognition of the investment?

Yes, although there should be greater scrutiny of the assumptions that companies have made, as small changes in the assumption on load factor will make a large difference in the benefits shown in the analysis.

Question 2: Do you agree with our proposal (common reporting, reporting lag) to address the issues associated with using settlement data to measure losses?

We agree that common reporting is essential. Whilst a lag addresses some of the settlement data volatility, the amount left still greatly exceeds any actions that we can take to reduce losses. Hence whilst it helps, it does not address the issues associated with using settlements data to measure losses. These can only be addressed by an input incentive or by direct simultaneous measurement of the flows on the network.

Question 3: What are your views on our proposals for a common reporting method and where we have identified options, which do you prefer?

We have no concerns with the method proposed provided that we can continue to use existing systems and data flows as indicated in the paper. Our preference would be to use the hybrid method described for CVA data. The final position should be calculated at DF rather than RF.

Question 4: Do you agree with our revised losses incentive value and our proposal to retain the rolling retention mechanism?

Rolling mechanisms are needed where there are concerns about DNOs delaying actions. Given the degree of volatility seen in settlements data, the actions of DNOs have little impact in each year. Hence we do not agree that the rolling retention mechanism is necessary.

If the existing incentive is to remain, then caps and collars are essential to protect both customers and shareholders from odd and unexplained swings in settlements data. The value of incentives must be ranked in accordance with the DNOs' ability to influence the parameter being incentivised. The cap and floor proposals are too wide and the application against the total DPCR5 loss performance may lead to significant swings in cash flow during the price control period. The gain/loss associated with the loss incentive should have an annual limit even if this is wider than that for the entire DPCR5 period.

Question 5: Do you agree with our proposal for a common treatment for substation energy usage, where the substation usage is registered with a supplier so that they pay for the electricity consumed?

Yes. Inclusion in losses hides real usage of electricity.

Question 6: Do you agree with our proposal to recognise and reward improvements to the losses measurement?

Yes. Settlements data measures both technical and non technical losses. Better system measurement of technical losses will enable better targeting of reducing technical losses which have an impact on carbon emissions. Hence it is correct to recognise and reward improvements in this area.

Chapter 7: Treatment of DPCR4 losses rolling retention mechanism

Question 1: Do you agree with our proposal to leave the DPCR4 losses incentive open for the first three years of DPCR5 until the settlement corrections are complete? What are your views on our proposal that the absolute losses performance will be exposed to the DPCR4 rolling retention mechanism?

As there are different methods being used by DNOs to calculate losses, and those using accrual accounts have the ability to manipulate data between years, it is inevitable that the loss incentive will need to be open for the first three years of DPCR5. Whilst the result of the loss roller is little more than a lottery in terms of the reward/penalty resulting, it is also inevitable that the absolute loss performance will be exposed to the rolling retention mechanism.

Question 2: Do you consider that the proposals for closing out the DPCR4 rolling retention mechanism have merit, and if so, how should we manage the uncertainty?

There is merit in closing down the DPCR4 losses roller; however it looks unlikely that agreement could be reached on a mechanism to do this.

Chapter 8: Business carbon footprint reporting

Question 1: Do you agree with our proposal for BCF reporting requirements?

We agree that the methodology should encompass Scope 1 and 2 emissions together with the subset of Scope 3 emissions covered by business travel and the contractor emissions related to the operational transport fleet and mobile power plant. We do not agree that extending Scope 3 reporting beyond that, to be either material or proportionate in the burden and cost it would impose on multiple small contractors.

Question 2: Do you agree with our proposed guidance for the BCF reporting methodology?

Yes, subject to the comment to Question 1 above.

Question 3: Do you agree with our proposal to rely on a reputational incentive only (through publication of a league table)?

Yes.

Chapter 9: Undergrounding in Areas of Outstanding Natural Beauty ('AONB's) and National Parks mechanism

Question 1: Do you agree with our proposed amendments to how the undergrounding allowance is formulated?

Yes. We support an overall cap of £100k per km of line with the removal of the individual voltage caps. The capped amount should be uprated annually for inflation. An overall cap will provide stakeholders with more flexibility in selecting schemes that have the greatest amenity benefit. It is also helpful to allow the undergrounding allowance to enhance normal replacement.

Question 2: Do you agree with our proposed approach to undergrounding projects not completed by the end of DPCR4?

Yes. It would be sensible to apply this rule to the DPCR5/6 boundary as well.

Chapter 10: Connections incentives and obligations

Question 1: Do you agree with the scope, timeframe and the level of penalties proposed for the guaranteed standards regime?

Yes, subject to the following conditions being met;

- Guaranteed Standards should not apply to unmetered supplies, unless the inventory has been independently demonstrated to be within a high level of accuracy.

- Guaranteed Standards should not apply to unmetered supplies where the use of the classification of "high priority" etc. is the choice of the customer, as this will lead to a disproportionate number of faults being reported in the high priority category. If a Guaranteed Standard is applied using these categorisations, at minimum the number of payments against any category should be subject to percentage caps based on the national average e.g. 12% for emergency and 3% for high priority.

- DNO income generated from individual un-metered supplies is extremely low and we do not believe that it is appropriate to place items such as advertising boards with the same weighting as street lighting.

- Unlimited liability of the proposed uncapped daily payments is not appropriate. Electricity connections should be capped at the same level as the gas industry. The use of a cap would be consistent with the existing electricity restoration guaranteed standards.

- Ofgem have identified that the proposed connections regime will involve significant changes to IT systems. DNOs will need a reasonable period to implement the required IT system changes. Ofgem need to finalise the connections RIGs and reporting templates as soon as practicable and allow a sufficient timescale for DNOs to implement IT changes and staff training.

Question 2: Should we develop a mechanism to ramp up the level of the proposed penalty payments?

We do not support any ramping up of penalty payments.

Question 3: Should we cap the penalties that apply to each of the proposed standards?

Yes. See response to Question 1 above.

Question 4: Should we apply in aggregate a 90% performance target to apply to the standards and measure this on a quarterly basis?

A target performance standard introduces a double penalty in the form of an enforcement fine, in addition to the unlimited guaranteed payments. The claw back of margin arising from licence breach on top of this gives a triple penalty. This is an unduly punitive regime.

Any monitoring of overall performance should be derived from the Guaranteed Standards performance so that only one set of quarterly reporting is required.

Question 5: Do you agree withy our market segmentation strategy for metered and unmetered connections? Are there any segments other than those identified that should be exempt from earning a margin?

We agree that the proposed protection for metered domestic customers and very small domestic developments, together with single small business customers, particularly in rural areas is necessary. We have very few EHV connections in a year, so this segment is more difficult to assess.

Question 6: What are your views on the proposed level of regulated margin and is there any further evidence we should take into account in setting the level of regulated margin?

We do not support the introduction of a margin.

Question 7: Do you have any comments on the scope of the proposed competition tests?

It is not appropriate that one of the competition tests should be based on assessing market share. Whilst competition is clearly evident around major cities in the South West and South Wales, WPD's territory includes extremely rural areas where competition is unlikely to be attractive to third parties.

Question 8: We invite views on the relative weighting of market share compared to the price and service tests. What level of lost market share would be appropriate to deem the market competitive?

We understood from the model that the tests for compliance, market share and price/service were pass/fail tests. There is no relative weighting.

Chapter 11: Broad measure of customer satisfaction

Question 1: Do you agree with the proposed scope of the broader measure?

Yes.

In relation to complaint handling, the principle of the Consumers Estate Agents and Redress Act is to make it easy for customers to complain and for companies to resolve issues quickly. Where companies cannot resolve complaints in a timely or appropriate way the customer has the right to seek alternative forms of redress via Ombudsman schemes. These principles are embedded in Ofgem's complaint handling standards.

It would give entirely the wrong signal to penalise DNOs who make it easy to complain and more appropriate to measure the quality of the experience and the effectiveness of DNOs in resolving complaints.

To maintain consistency with Ofgem's complaint handling standards, the complaints metric should therefore be based on the number or percentage of complaints not resolved by the end of the next working day, the number that are referred to the Ombudsman and the number that are upheld by the Ombudsman.

Question 2: Do you agree with the revenue exposure and the incentive weightings proposed for each element?

Yes.

Chapter 12: Telephony incentive scheme

Question 1: Do you agree with the proposed improvements to the telephony scheme?

Yes, the introduction of unsuccessful calls is important.

The telephony scheme should be amalgamated into the proposed broader measure in 2012 to ensure continued focus on both the response a customer receives from a DNO when reporting a loss of supply and the number of unsuccessful calls.

Question 2: Do you agree with our proposals and methodology for recasting the reward and penalty thresholds?

Yes.

Chapter 13: Worst-served customers

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

We agree with the introduction of the mechanism and the criteria and requirements set out in Initial Proposals. The funding of the mechanism should be ex-ante.

Question 2 Do you agree with the level of the proposed cap per benefiting customer? If not, what level do you believe is appropriate?

Yes.

Chapter 14: Interruptions Incentive Scheme (IIS)

Question 1: Do you agree with the proposal that any required improvement from current performance levels should be funded by shareholders?

In relation to CMLs only we agree with Ofgem's proposal that any required improvement from current CML performance levels should be funded by shareholders. WPD have demonstrated that CML performance can be improved by the implementation of operational practices that have no material impact on operating costs.

We do not agree with Ofgem's proposal that the non load related capital expenditure required to improve unplanned CI performance from current levels to the Ofgem targets should be funded by shareholders.

Firstly, current unplanned CI performance is predominantly a consequence of previous network investment. Customers of those DNOs that perform better in respect of unplanned CIs have funded that previous investment. Customers of those DNOs who perform poorer in respect of unplanned CIs have funded less investment. Ofgem's proposal is inequitable.

Secondly, Ofgem's proposal is inconsistent with other aspects of Ofgem's non load related capital expenditure proposals which are intended to provide DNOs with sufficient funding to maintain network risk at prevailing levels and to meet new obligations. For example within the asset replacement capital expenditure category DNOs are maintaining both the probability of an unplanned incident occurring and the consequence of an unplanned incident at their prevailing levels. Yet under the IIS, if all DNOs were to maintain unplanned CIs at their prevailing level, some DNOs would be penalised whilst for other DNOs there would be no financial impact. This inconsistency is not acceptable.

Finally, the incentive rates, as set out in the Initial Proposals, will not guarantee the capital investment necessary to improve CI performance. For example, the interest charges associated with the investment required to achieve the CI targets for WPD South Wales marginally exceeds the sum of the CI penalties avoided and the CML rewards.

Overall, in respect of unplanned CI performance, if funding to improve unplanned CI performance is not included in Ofgem's baselines, we propose that DNOs should not be set unplanned CI improvement targets. Our proposal would be consistent with aspects of Ofgem's non load related capital expenditure proposals and recognise the differential levels of network investment previously funded by customers.

Question 2: Do you agree with the approach to setting pre-arranged allowances?

We do not agree with the approach that Ofgem have used to derive pre-arranged allowances for both CI and CML as it is fundamentally flawed. The approach used by Ofgem produces unrealistic targets for WPD, which would result in an aggregate financial penalty in excess of £8.0m for the DPCR5 period.

This is a perverse consequence of the approach used by Ofgem, as the WPD DNOs are currently two of the best performing DNOs in respect of pre-arranged incidents, whilst CN East is one of the worst performing DNOs. The tables below show, for the four year period 2005/06 to 2008/09, the average number of CI and CML per pre-arranged incident.

Average CI Per Pre-Arranged Incident in the Four Year Period 2005/06 to 2008/09				
	All DNO Average	WPD South Wales	WPD South West	CN East
HV Pole Mounted or Overhead	35	28	19	45
HV Ground Mounted or Underground	46	44	22	47
LV Pole Mounted or Overhead	17	15	13	20
LV Ground Mounted or Underground	33	28	27	39
Total	**30**	**26**	**17**	**38**

Average CML Per Pre-Arranged Incident in the Four Year Period 2005/06 to 2008/09				
	All DNO Average	WPD South Wales	WPD South West	CN East
HV Pole Mounted or Overhead	9091	4094	4561	11527
HV Ground Mounted or Underground	10257	3328	3007	10630
LV Pole Mounted or Overhead	4572	2646	2908	5197
LV Ground Mounted or Underground	7031	3390	3625	5411
Total	**7385**	**3609**	**3580**	**9006**

From the tables above it is evident that both WPD DNOs perform better than the average DNO across all categories, whereas CN East perform worse than the average DNO across the vast majority of categories. Yet perversely, Ofgem's approach results in CI targets for WPD South Wales and WPD South West that are 56% and 72% respectively of the DNOs forecasts, whereas the CI targets for CN East are 100% of their forecast.

The fundamental flaw in Ofgem's approach relates to the selection of incorrect and invalid drivers as described below. In general, Ofgem have used expenditure associated with each of the four activity types as the driver of pre-arranged CI and CML.

1. Load Related Expenditure

   Ofgem have used net load related capital expenditure as the driver of CI and CML due to pre-arranged incidents associated with load related activities. The use of net load related expenditure as the driver is not correct. The correct driver is gross load related expenditure. However, it will be necessary to adjust gross load related expenditure for capital efficiency.

   Ofgem's Network Investment team have undertaken an analysis of each DNO's unit costs for undertaking capital works. This analysis has revealed a material difference in capital efficiency across DNOs. WPD has been identified as the most capital efficient DNO. The use of gross load related expenditure that has not been adjusted for capital efficiency would favour the inefficient DNOs such as Central Networks and disadvantage efficient DNOs such as WPD.

   In addition, there is an issue specific to WPD. Our load related forecast expenditure for DPCR5 for both WPD South Wales and WPD South West includes discretionary expenditure associated with a project to install smart metering at all secondary substations. On page 39 of the commentary accompanying our February 2009 FBPQ submission we clearly state "The impact on quality of supply performance associated with the installation of smart meters at all secondary substations has not been included in our FBPQ." However, Ofgem analysis has a mismatch as the analysis includes the discretionary expenditure but excludes the pre-arranged CI and CML associated with the discretionary expenditure.

2. Non Load Related Expenditure

   Ofgem have total non load related capital expenditure as the driver of CI and CML due to pre-arranged incidents associated with non load related activities. The use of total Non Load Related expenditure as the driver is not correct.

   The tables below shows the percentage make up the aggregate CI and CML due to pre-arranged incidents.

Composition of Aggregate CI Per Pre-Arranged Incident During the Four Year Period 2005/06 to 2008/09				
	All DNO Average	WPD South Wales	WPD South West	CN East
132 kV & EHV Network Incidents	0%	0%	0%	0%
HV Pole Mounted or Overhead	43%	63%	39%	38%
HV Ground Mounted or Underground	22%	20%	10%	39%
LV Pole Mounted or Overhead	20%	15%	34%	14%
LV Ground Mounted or Underground	14%	3%	16%	8%
Total	**100%**	**100%**	**100%**	**100%**

Composition of Aggregate CML Per Pre-Arranged Incident During the Four Year Period 2005/06 to 2008/09				
	All DNO Average	WPD South Wales	WPD South West	CN East
132 kV & EHV Network Incidents	0%	0%	0%	0%
HV Pole Mounted or Overhead	46%	68%	45%	42%
HV Ground Mounted or Underground	20%	11%	7%	38%
LV Pole Mounted or Overhead	22%	19%	37%	16%
LV Ground Mounted or Underground	12%	2%	11%	5%
Total	**100%**	**100%**	**100%**	**100%**

From the tables above it is evident that pre-arranged incidents on the 132kV & EHV networks make negligible contribution to the CI and CML. Therefore, it is wholly inappropriate to include any aspect of Non Load Related expenditure associated with the 132kV & EHV networks a driver of pre-arranged CI and CML.

In addition, it is also evident that the composition of both CI and CML due to prearranged incidents is not uniform across DNOs. For WPD South Wales and WPD South West the percentages of pre-arranged Customer Interrupted associated with LV & HV pole mounted and overhead are 87% and 82% respectively. Corresponding figures for the all DNO average and CN East are 68% and 58% respectively. Earlier we showed that in respect of both LV & HV pole mounted and overhead pre-arranged incidents, both the WPD DNOs performed better than the average DNO. So both of WPD's DNO's perform

better than average in activities that account for more that 80% of the total pre-arranged CI, yet Ofgem's approach results in CI targets for WPD South Wales and WPD South West that are 43% and 63% respectively of the DNOs forecasts. This is perverse.

It is noticeable that the three DNOs with the highest percentages of overhead line on their networks; i.e. SSE Hydro, WPD South Wales and WPD South West are the only three DNOs that have their forecasts for CI due to non load related pre-arranged incidents adjusted by Ofgem. This suggests that Ofgem's approach fails to accommodate differences in the network characteristics of DNOs.

There are other categories of non load related expenditure that do not drive pre-arranged CI and CML. Such categories include:

- Major system risks;
- Operational IT and Telecomms;
- Black start;
- Emergency batteries;
- Critical National Infrastructure;
- Site Security;
- Asbestos clearance;
- Safety climbing devices;
- Rising mains and laterals;
- Technical losses;
- Oil pollution – Mitigation; and
- SF6 leakage.

Therefore, it is wholly inappropriate to include such categories of Non Load Related expenditure in the driver of pre-arranged CI and CML.

On balance, the driver of pre-arranged CI and CML due to non load related expenditure would be those categories of expenditure that necessitate pre-arranged outages on the LV & HV networks. However, these categories of expenditure would need to be adjusted for capital efficiency and normalised to cater for differences in DNOs' network characteristics.

Ofgem's Network Investment team have undertaken an analysis of each DNOs' unit costs for undertaking capital works. This analysis has revealed a material difference in capital efficiency across DNOs. WPD has been identified as the most capital efficient DNO. The use of capital expenditure that has not been adjusted for capital efficiency would favour the inefficient DNOs such as Central Networks and disadvantage efficient DNOs such as WPD.

3. Inspections & Maintenance and Tree Cutting

Ofgem's Cost Review team has undertaken a great deal of analysis to normalise operating activities and undertake comparative efficiency analysis. This work has revealed a material difference in the efficiency of operating activity expenditure. The determination of CI per £m (and CML per £m) of activity (i.e. Inspections & Maintenance and Tree Cutting) should be based on the efficient level of operating activity expenditure.

Ofgem's current approach for determining pre-arranged CI and CML disadvantages efficient DNOS such as WPD.

Question 3: Do you agree with the proposed levels of revenue exposure and incentive rates?

We agree with the proposed level of revenue exposure. However, as we have indicated above, the incentive rates, as set out in the Initial Proposals, will not guarantee the capital investment necessary to improve CI performance. For example, the interest charges associated with the investment required to achieve the CI targets for WPD South Wales marginally exceeds the sum of the CI penalties avoided and the CML rewards.

Question 4: Do you agree with the proposed refinements to the exceptional events mechanism?

Yes.

Chapter 14: Other Issues

Unplanned CI Targets

The unplanned CI targets for the DPCR5 are influenced significantly by the underlying or average performance during DPCR4. During 2008/09 the unplanned CI performance during 2008/09 was exceptional for both WPD South Wales and WPD South West. The primary reason for this exceptional performance was the low number of unplanned incidents experienced.

The table below compares our actual unplanned CIs during 2008/09 with the average, minimum and maximum unplanned CIs during the preceding five year period 2003/04 to 2007/08.

Unplanned CI Performance		
	WPD South Wales	WPD South West
2008/09 Actual	62.9	64.9
Performance during preceding five year period 2003/04 to 2007/08		
- Minimum	74.7	67.7
- Average	83.5	71.8
- Maximum	95.6	78.0

Our actual performances during 2008/09 expressed as percentages of the average performances during the preceding five years are 75% and 76% for WPD South Wales and WPD South West respectively. The corresponding percentages for other DNOs range from 80% to 108%.

Our analysis indicates our unplanned CI performances during 2008/09 are outliers that have disproportionate impacts on the determination of the underlying unplanned performance during DPCR4. A reduced weighting should be applied to our 2008/09 unplanned CI performance.

Unplanned CML Targets

We note that 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 WPD South Wales and WPD South West 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.

The unplanned CML target for both WPD South Wales and WPD South West are too demanding. We explained above that our unplanned CI performances during 2008/09 were outliers and that a lower weighting should be attached to them. This same issue is evident for unplanned CML.

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% of revenue per annum in recognition of the economic value that WPD add. This would be consistent with the treatment during DPCR4.

Chapter 15: Guaranteed standards of performance

Question 1: Do you agree with the proposal to increase guaranteed standard payment levels to reflect inflation?

Yes.

Question 2: Do you agree with the proposal to introduce some form of payment cap for large one-off events?

We agree that the Guaranteed Standards should be aligned to the IIS exceptional event categories to cover exceptional events affecting a large number of customers. Rather than a payment cap the IIS exceptional event rules should be added to the list of exemptions from the normal and severe weather standards i.e. no payments made to customers.

As the effects of climate change become more noticeable, we can also see merit in a cumulative cap on Guaranteed Standards payments in severe weather. A DNO could be hit with an increasing number of severe weather incidents over a year. It would be reasonable to limit exposure under these circumstances. WPD has shown itself to be very efficient at responding to severe weather incidents. Ofgem would need to develop guidance further to ensure that such a mechanism was fair and did not support DNOs who are less efficient at dealing with such incidents.

Question 3: If you agree to the introduction of some form of payment cap, what is your preferred method?

With regard to the cumulative cap, once payments exceeded a certain amount, the guarantee would need to be suspended.

Question 4: Do you agree that rota disconnection interruptions should be treated independently of the multiple interruption standard?

Yes. The multiple interruption standard was intended to relate to repeated unplanned outages.

Chapter 16: Customer Service Reward Scheme

Question 1: Do you agree with our proposals for embedding DPCR4 best practice?

We agree that to retain flexibility and incentivise innovation, best practice should be embedded in the scheme rather than via the licence.

Question 2: Do you agree that the scheme should be rationalised once the Broad Measure goes live in April 2012? If so, in which areas?

We agree that from April 2010 there will be few areas of customer service that are not subject to a detailed incentive scheme or other reporting requirements. Therefore streamlining the reward scheme may be appropriate.

In order to enable DNOs to plan and implement meaningful long term projects, it is important that the detailed criteria are set well in advance, ideally by April 2010 for the two years 2010/11 and 2011/12 and April 2012 for the remaining 3 years of the price control.

Chapter 17: Network Output Measures

Question 1: Is our proposed common methodology for network output measures related to general reinforcement and asset replacement expenditure appropriate?

Yes. We are supportive of the continued development of output measures for general reinforcement and asset replacement.

Consideration should be given to a reward for DNOs who out-perform against the output measures.

Question 2: Is our proposed process for determining whether a DNO has performed satisfactorily against its agreed DPCR5 outputs appropriate?

We agree that a mechanistic assessment is not appropriate. The output measures are still at a relatively early stage of development, and there is a high degree of uncertainty in forecasts of load growth and asset condition degradation. We agree that the process for determining performance therefore needs to be more holistic based on detailed discussions with the DNOs.

Question 3: What approach should be taken if we determine that a DNO has failed to deliver against its agreed DPCR5 outputs? Have we considered all reasonable options to impose financial consequences for under-performance?

Although good progress has been made between the DNOs and Ofgem, output measures are still at a relatively early stage of development, and their sensitivity and movement due to variations in inputs and methodology of calculation are currently unknown. The proposed assessment of performance will be based on a qualitative view and detailed discussion between Ofgem and the DNO. For these reasons it is not appropriate to impose direct financial penalty during DPCR5. However we agree that a DNO that has been deemed to have under-performed should be subject to much greater scrutiny on its network investment at DPCR6. The further development and working experience gained through the DPCR5 period will allow appropriate financial penalties/rewards to be set for implementation at DPCR6.

Question 4: Should we apply different treatment to DNOs that fail to deliver the agreed DPCR5 outputs, depending on their level of DPCR5 investment relative to the forecast?

It would be reasonable that different treatment is applied to a DNO that fails to deliver the outputs and has invested less than its forecast, compared to one that has similarly failed, yet invested beyond its forecast. In order to apply different treatment it may be necessary to consider the efficient investment that would have been required by each DNO to achieve its output targets.

Chapter 18: Innovation Funding Incentive (IFI)

Question 1: Do you agree with our proposal to retain IFI?

Yes. Given the experience now gained in operating IFI, we believe that there is scope for a limited general relaxation of the permitted percentage of internal expenditure, to perhaps 20%. This arises because a conflict is generated between seeking highly geared multi-partner projects, such as Supergen Amperes or Climate Impacts research, and then actively participating in that work .

Question 2 Do you agree with our proposal to focus IFI on technical R & D, whilst creating the new low carbon network fund for the trialling of low carbon initiatives on the networks?

Yes, in so far as we interpret "Technical R&D" to mean IFI Projects compliant with Engineering Recommendation G85, issue 2. If Ofgem intend a different interpretation this should be clarified before final proposals.

Chapter 19: Equalising incentives and the information quality incentive

Question 1: Does the 85 % capitalisation of all costs within the equalised incentive provide an appropriate speed of money?

The principle of equalising incentives is correct. However, the proposal to split IQI-able costs so that 85% is funded as slow money and 15% is funded as fast money is incorrect as it is materially different to the treatment in the last price control.

Under DPCR4 rules applied to DPCR5 costs 74% of IQI-able costs are funded as slow money.

This ratio must be maintained for DPCR5.

Question 2: Does the IQI matrix presented provide an appropriate profile for the incentive strength? Should we be considering an alternative profile with a steeper incentive rate?

We agree with the current proposal.

Question 3: What approach should we adopt when setting the start to earn points of the IQI matrix?

We agree with the proposed approach.

Allowed revenue – Cost Assessment

Chapter 1: Overview of our approach to cost assessment

Question 1: Have we taken an appropriate approach to assessing costs?

No. In the May Initial results paper Ofgem's analysis of operating costs and modelling was 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 paper Ofgem has, inexplicably, failed to adhere to its approach as presented and has introduced a number of changes without justification or explanation.

We set out in detail the errors in Ofgem's approach in our response to Question 3, Chapter 1 of the Initial Proposals document.

Question 2: What mechanism should be used to fund high value projects?

We would favour the third option discussed in Initial Proposals i.e. part funding upfront with an ex post adjustment during the price control depending on the actual investment made. A cap set in advance on total amount of fund allowed for each project.

Question 3: What assumptions do you think we should use for real price effects and ongoing efficiencies for DNOs over the 2010-15 period?

See response to Question 2, Chapter 3 of the Initial Proposals document.

Question 4: Do you agree with our proposed methods for handling uncertainty?

Yes.

Question 5: Are our proposals for volume drivers on low-cost connections involving shared assets proportionate, ie is the mechanism necessary?

There is still some work required to understand the large variation in both gross and net average cost per connection. Once this is complete we acknowledge that a different unit cost per DNO may still be appropriate. However this should not penalise a DNO that already provides an efficient cost of connection, while allowing an inefficient DNO to continue at an inefficient rate.

It should also be noted that to disaggregate connection counts and costs into the proposed high volume low cost activities categories, some changes to DNO systems would be required.

Question 6: What is an appropriate materiality threshold for the operation of our proposed load related expenditure reopener?

Although not directly visible from the Initial Proposals documents, the forecast Ofgem baseline general reinforcement combined with the DUoS funded high-cost, low-volume investment for each DNO appears to be in the range of £20m through to £200m. Hence a simple 20% threshold for a reopener may lead to a reopener at a £4m threshold, which is probably not material. Consideration should be given to a threshold of 20 % subject to a minimum value of £10m.

With regard to demand connections, the justification for the reopener outlined within Initial Proposals Allowed Revenue Cost Assessment 6.12 requires the DNO to demonstrate this is due to work volumes 'rather than unit cost differences, which is a risk to be managed by the DNO.' Although we agree in general that unit cost should be managed by the DNO, when considering high-cost, low-volume connections, and then only the element that is DUoS funded, this presents a highly volatile equation – for example a single EHV connection may require reinforcement of a 132/33kV substation at significant cost, however the DUoS funded element is simply defined by the apportionment rule (the ratio of the new connection load to the resultant network capacity following reinforcement).

Question 7: Does the GDPCR reopener for TMA costs provide a good template for our final DPCR5 proposals for these costs?

We support the retention of a reopener for TMA costs. There is still a significant uncertainty over the timing of these costs. The approach adopted in the Gas DPCR appears sensible.

Allowed Revenues and Financial Issues

Chapter 1: Cost of Capital

Question 1: Do you think that PwC have identified an appropriate range for setting the cost of capital?

No.

See our comments on the cost of debt above.

Question 2: How should we balance our standard long-term view of the cost of capital with current indicators in the capital markets?

See our comments on the cost of debt above.

In taking a long term view going forward Ofgem should however be realistic about whether the market conditions that prevailed in the past will continue to be available in the future – it is not sufficient to use a 10 year average of past market conditions to set future allowances.

Question 3: Which, if any, of the alternative methods of dealing with variability in the cost of debt should we adopt?

We do not favour any of the alternative methods of dealing with variability.

Question 4: What are the pros and cons of the mechanistic debt trigger as suggested by PwC?

The mechanisms proposed by PwC are complex and untested so we do not favour such an approach.

Chapter 2: Regulatory asset values (RAV)

Question 1: Do you agree with the draft rules for computing RAV additions and will they reduce or eliminate boundary issues at DPCR5? If not how should they be amended?

We agree with the draft rules.

Question 2: In what circumstances would you consider it appropriate to have DNO-specific RAV additions percentages?

The principle of equalising incentives is correct. However, the proposal to split IQI-able costs so that 85% is funded as slow money and 15% is funded as fast money is incorrect as it is materially different to the treatment in the last price control.

Under DPCR4 rules applied to DPCR5 costs 74% of IQI-able costs are funded as slow money.

This ratio must be maintained for DPCR5.

Chapter 3: Excluded Services

Question 1: Do you agree with our proposal to bring the distribution of units to new EHV premises, provision of charging statements and reactive energy transportation within the scope of the main charge restriction conditions?

We do not agree that the distribution of units to new EHV premises should be brought within the main charge restriction conditions. The lack of forecast for such new connections does not mean that they will not happen, but that customers have not approached us at this point in time. The uncertainty of whether there will or will not be connections at this voltage is why they need to be excluded.

Due to the ready availability of charging statements on websites, we agree with the removal of this as an excluded service.

As the calculation of reactive power charges will fall under the CDCM and its governance process, there is a likelihood that the method of calculation and hence value will change during DPCR5. Hence we agree that it would be better to include these within the main charge restriction conditions.

Question 2: Do you agree that revenue protection services should be exempt from a RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party?

Yes.

Question 3: Do you agree with the proposed RAV adjustments for top up and standby, other system charges and metering excluded services where reported revenues (costs in the case of metering) exceed forecasts

Whilst agreeing that these services should remain as excluded services, we do not agree that revenues in excess of forecast should be deducted from totex cost entering RAV. This is because where new services are required by customers (e.g. a development expecting to run on embedded generation but occasionally requiring top up and standby services due to failures of generators) such a treatment would discourage us from wanting to provide them.

Question 4: Do you agree with our proposals with regard to diversion works in DPCR5?

Yes.

Question 5: Do you agree with our proposals regarding metering excluded services?

See response to Question 3 above.

Chapter 4: Corporation tax allowances

Question 1: Do you agree with our position on the tax methodology?

Ofgem have stated that their primary objective is to incentivise DNOs to manage their tax affairs efficiently. As the tax paid by a company is determined by the accounting policies and the application of the tax regime which is governed by statute, case law etc, it is hard to understand how Ofgem can do so.

That said, the current methodology used by Ofgem for calculating a reasonable allowance for DNOs corporation tax costs is a vast improvement on that used for DPCR4.

Appropriate opening capital allowance pools

Ofgem are proposing to use opening tax pools derived from the latest submitted tax return projected to the end of the current price control period. We agree that this is the right position to take, and not the balance as calculated under the previous DPCR4 period assumptions.

However, we still have an issue with respect to the treatment of fault costs for tax purposes in DPCR4 and the knock-on effect in DPCR5, and we will be writing separately on this issue.

Company-specific compared to common allocation basis

Ofgem have accepted that using a generic allocation of capital expenditure over the different capital allowance pools does not adequately reflect the actual position. Following consultation with the DNOs, the analysis of capital expenditure in the FBPQ was considerably extended thus allowing each DNO to allocate their individual tax treatment. This information was used by Ofgem to derive a common approach to the allocation of capital expenditure.

If Ofgem are trying to calculate a reasonable tax allowance and also end up with capital allowance pools that closely reflect the tax return position of the DNO at the end of DPCR5 period, it would be more reasonable to use the data compiled in the FBPQ to derive a company-specific allocation basis as the tax allowances are derived from the pattern of capital expenditure of each individual DNO.

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

Attribution to capital allowance pools

Table 1 on page 75 incorrectly shows easements expenditure categorised as revenue for tax purposes when this should be in the non-qualifying category.

Question 2: Do you agree with the proposal to establish a tax trigger mechanism and that we have established an appropriate balance between incentivising DNOs to manage their tax risks and sharing the risks and rewards with consumers?

We agree with the proposal to adopt a tax trigger mechanism, and that the trigger point should be set as a % of regulated revenue. However we would reiterate the point that it is the DNO's accounting policies that drive the tax calculations so there is limited opportunity to 'manage' the tax charge.

Ofgem have set out five criteria that should apply to events that would activate the trigger and we agree that these are fair and reasonable. However we cannot agree with the areas that Ofgem have specifically excluded, particularly due to the effect of a change in case law before the start of DPCR4. Our view is that all these areas should be included and it is the criteria that determine activation of the trigger mechanism.

It is also unclear as to how the change to DNOs' revenues will be measured and we would ask Ofgem to set out this methodology so that there are no surprises when the trigger is activated.

Chapter 6: Revenue allowances and financial modelling

Question 1: Do respondents agree that we have appropriately identified the scope of the price control, ie are we making allowances for the right categories of costs?

Yes.

Question 2: How do respondents think we should profile allowed revenues over the 2010-2015 period?

Allowed revenues should be profiled as a constant increase through years one to five of DPCR5.