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Dear Rachel

**September Update to Initial Proposals**

1. Many thanks for giving us the opportunity to provide further input to the DPCR5 process through the September Update letter. We appreciate the transparent way in which policy is being developed through DPCR5, and Ofgem's continued engagement with all stakeholders ahead of Final Proposals.
2. The September Update (and subsequent October Update) addresses a number of issues that will have a major commercial impact on our business in coming years. As we set out in our response to Initial Proposals, we are facing an unprecedented period of uncertainty over the future level of electricity distribution charges. In April 2010, customers will face price changes resulting from the new price control settlement as well as changes proposed by the networks in introducing a common charging methodology.
3. The latest model accompanying Ofgem's October Update suggests that DPCR5 will lead to an average movement in charges of 13% for customers in April 2010. As you are aware, we believe this number may significantly understate the % DUoS increases which would be required based on current (October Update) allowed revenue projections.
4. As a consequence, Ofgem's final views on cost assessment and measures to limit the impact of uncertainty on customers are of key importance to us. In the remainder of this response we therefore comment on these two areas in turn.

## Updated revenue and cost allowances

5. We understand from the October Update that further cost updates from the DNOs have resulted in Ofgem increasing the proposed cost allowances for the DNOs by an additional £0.75bn (comprising increases to both network investment and business costs). Fundamentally, we do not see any justification for these increases. As we set out in our previous response, we believe that there are numerous areas where the DNOs have been treated generously under Initial Proposals. These include:
  - the requirement for the most inefficient DNOs to only meet “median” levels of unit costs for asset replacement capex (rather than a more stretching requirement for all DNOs to meet upper quartile levels of unit costs);
  - a generous allowance for general reinforcement expenditure, which will increase by nearly 20% in DPCR5 compared to DPCR4 (despite National Grid’s latest demand forecasts showing almost no increase in national peak demand forecasts over DPCR5);
  - the proposed approach for benchmarking of network operating costs in which the most inefficient DNOs are only required to meet average levels of efficiency (rather than a requirement for all to meet upper quartile levels);
  - relatively unchallenging frontier shift increases in opex efficiency of 1% per annum (compared to 1.5% in DPCR4 and 4.4% in DPCR3); and
  - assumptions of positive real price effects in opex where there seems to be little evidence of such increases at present (and in the context of an assumption of zero real price effects assumed for capex costs).
6. As a consequence, we believe that the increase in cost allowances announced in the October Update will serve to further reduce the level of risk that DPCR5 represents to the DNOs.
7. In the event that Ofgem adopts the latest view on cost allowances in Final Proposals, we believe that customers will only get a fair deal from DPCR5 if this is fully reflected in the level of cost of capital that the DNOs receive. As you will be aware, as part of our response to Initial Proposals, we submitted a paper on cost of capital commissioned from CEPA. In this paper, CEPA stated that:

“Before concluding on the allowed WACC, we have reviewed the relative risk of the proposed regulatory settlement for DPCR5 with that of DPCR4 and Ofwat’s PR09. We conclude that DPCR5 is, *prima facie*, less risky than the current DPCR4, and is likely to be of similar or

potentially lower risk compared to Ofwat's PR09 (based on the draft determination)."

8. We believe that the revised allowances will only serve to further mitigate the level of risk that DPCR5 represents to the DNOs, therefore arguing for a cost of capital firmly at the lower end of CEPA's proposed range.

#### **Use of reopeners, logging up and hybrid mechanisms**

9. As you are aware from our previous responses, we fully support Ofgem's view that managing risk is an important theme for DPCR5. We continue to believe that customers will tend to gain the best value outcome if networks retain those risks that they are most able to control, and which they can reasonably be expected to manage at lowest cost.
10. However, we do recognise that there are a number of risks facing DNOs in DPCR5 which may have significant cost implications for the networks, yet over which DNOs can exert little control – for example, costs relating to the Traffic Management Act.
11. While we believe it is appropriate that such costs are passed-through to customers, we believe it is also important to recognise that price control reopeners directly contribute to a lack of predictability in network charges. This imposes significant costs on suppliers – and to the extent that they lead to volatile prices and risk premia, on end customers. For this reason, we have proposed in previous responses that reopeners should be associated with a "logging-up" mechanism which would:
  - create a "running total" for reopeners assessed by Ofgem during DPCR5;
  - aggregate the charging impact of all reopeners (while netting off any reopeners that benefit customers) at the end of DPCR5; and
  - be collected from customers in DPCR6 on an NPV-neutral basis.
12. Such a mechanism would mitigate charging uncertainty during DPCR5 (as there would be no impact on network charges from reopeners until DPCR6), while also ensuring that the networks were fully recompensed for any reopeners approved by Ofgem.
13. Following Initial Proposals, we understand that concerns have been raised by some networks that the logging-up mechanism set out above could lead to financing issues for some networks (depending upon the materiality of reopeners raised by networks during DPCR5). To the extent that Ofgem considers these concerns are material, we believe that there is an alternative model to the "pure" logging-up mechanism that would represent an appropriate compromise between financing issues raised by the networks, and the need to maintain predictability of charges. This would be the specification of a single reopener "window" during DPCR5.

14. Under a single reopener window approach, any reopeners submitted by DNOs and assessed by Ofgem in the first half of DPCR5 (e.g. by end September 2012) could be “logged up” and applied to charges (on an NPV-neutral basis) from 1 April 2013. Any subsequent reopeners could then be logged up on a similar basis and be applied to charges at the start of DPCR6. This compromise proposal would mean suppliers (and ultimately end customers) would only be exposed to a single change in charges related to reopeners, which would represent a significant improvement over current arrangements in which reopeners can be applied to charges throughout the control period. As part of this approach, we would expect the networks to keep us regularly updated on the extent of potential reopeners so that we can build these into our forecasts.
15. As with the “pure” logging-up model, a single reopener window should also take account of the offsetting nature of many of the risks facing DNOs (with reopeners applying to the net outturn of risks facing them across the price control as a whole). This is a fairer way of mitigating risk than a mechanism in which DNOs are able to “cherry pick” reopeners for adverse events, while allowing DNOs to enjoy the windfall gains of those risks that outturn in their favour.

Once again, I'd like to reiterate that we welcome the opportunity to comment on the DPCR5 proposals at this late stage, and I hope that these comments are helpful. Please do let me know if you would like to discuss any aspect of this letter in more detail.

Yours sincerely



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