Promoting choice and value for all customers

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Date: 5 October 2009

Dear Colleagues,

October Update to Initial Proposals

1.1. Our Initial Proposals, published in early August 2009, outlined our view of the maximum revenues each DNO should be allowed to collect from customers between 2010 and 2015. Since then we have received a range of high level and detailed comments on our cost analysis and financial modelling from each of the DNOs and collectively through the ENA. We are grateful to DNOs for bringing forward these comments quickly. The transparency we have provided around our work, including in the May document, has allowed DNOs and others to scrutinise it and pick up errors, omissions and unintended consequences. This feedback has allowed us to refine our methodologies and make our results more robust.

1.2. In my letter of 14 August I committed to providing each DNO with an update setting out the changes we have made to the cost assessment, and the impact this has on our results and on the cost baselines and allowed revenue for the companies in each DNO group. We also committed to providing an update on any corrections or omissions to the financial model. This is the purpose of this letter and its attachments.

1.3. Over the last few weeks we have worked through the comments and issues raised after the publication of Initial Proposals, we have considered additional information that the DNOs have provided, including updates to their FBPQs, and we have undertaken the work signalled in Initial Proposals, to revise our adjustments for insourcing and outsourcing. We have addressed all of the errors and omissions that DNOs have pointed out to us and have taken significant steps to address many of the matters raised with us in August and September. Where we have not taken on board matters raised by the DNOs it is because we have not considered it necessary or appropriate to do so. In many cases the updates we have made to our cost analysis have not made a significant difference to the overall revenue numbers. A large proportion of the changes to allowed revenue relate to updates and improvements in the financial model. The changes to our cost assessment has had a material impact on the relative efficiency across the DNOs.

1.4. This letter provides:

- an overview of the key changes we have made to our cost assessment work,
- an explanation of the key areas where, after further review of your responses we have decided not to revise our approach,

- the impact of our updated analysis on the cost baselines for the companies in your group,
- an overview of the changes we have made to our financial modelling, and
- the impact on the allowed revenue for the companies in your group.

1.5. The Appendices to this letter set out issues logs covering additional points raised in your comments on the Initial Proposals cost assessment that have not been addressed elsewhere, further detail on pensions and our excluded services and bad debt adjustments.

1.6. Since Initial Proposals, we have changed the calculation of pensions costs to correct for errors and omissions. We have not changed our treatment of pensions costs or prejudged the outcome of our consultation on this matter. We will publish our "minded to" position on pensions policy for DPCR5 in mid October.

1.7. In our September update we set out for consultation our latest analysis for demand connections, a number of areas of non-core network investment and traffic management costs. We have incorporated these proposals into the allowances set out in this letter, although we note that our approach in these areas may change slightly to accommodate comments made to the September update.

1.8. Finally, the cost and revenue allowances in this letter are based on the same view of real price effects (RPE) and the scope for ongoing efficiency as we set out in Initial Proposals. We will review the appropriateness of the RPE forecasts presented in this area before final proposals. This will enable us to take account of the latest information that is relevant in setting the assumption for 2009-10 and forecast years. We have engaged CEPA to carry out a review of the information we have received from each of the DNOs and other stakeholders following Initial Proposals and to update their analysis. It is also important that these factors are considered in the round with decisions on the cost of capital, the calibration of incentives and the development of uncertainty mechanisms.

Overall allowed revenue

1.9. Our updated proposals for your allowed revenue are summarised in Table 1. The overall effect of the update is to increase your allowed revenue we set out in Initial Proposals by £94.2m or 8 per cent for CE NEDL and £119.4m or 8 per cent for CE YEDL.

Table 1 – Allowed Revenue CE

£m (2007-08)	Initial Proposals		October Update		Change (October - IP)	
DNO	Allowed	Average X	Allowed	Average X	Allowed	Average X
CE NEDL	1156.3	6.99%	1250.6	6.21%	94.2	-0.78%
CE YEDL	1443.9	5.60%	1563.4	4.58%	119.4	-1.02%
Total	2600.3	6.21%	2813.9	5.29%	213.7	-0.91%

Overall cost allowances

1.10. Our updated proposals for our total cost allowances are summarised in Tables 2 and 3 below.

Table 2 – Total cost allowances excluding the impact of costs recovered through reopeners and logging up mechanisms CE

£m (2007-08 prices)		Initial Proposals			October Update			Change (October - IP)		
DNO	DPCR4 actuals	DPCR5 Forecast	Baseline	Reduction (%)	DPCR5 forecast	Baseline Updated	Reduction (%)	DPCR5 forecast	Baseline	Reduction
CE NEDL	608	826	706	14%	847	790	7%	21	84	-8%
CE YEDL	775	1077	925	14%	1138	1020	10%	61	95	-4%
Total	1383	1902	1631	14%	1984	1810	9%	82	179	-5%

Note: we have excluded areas of costs recovered through a reopener a logging up mechanism from the IP forecast and baseline, as well as October update forecast and baseline in this version of the table.

Table 3 – Total cost allowances including the impact of costs recovered through reopeners and logging up mechanisms CE

£m (2007-08 prices)		Initial Proposals			October Update			Change (October - IP)		
DNO	DPCR4 actuals	DPCR5 Forecast	Ofgem allowance	Reduction (%)	DPCR5 forecast	Ofgem allowance updated	Reduction (%)	DPCR5 forecast	Ofgem allowance	Reduction
CE NEDL	608	828	709	14%	849	790	7%	21	81	-7%
CE YEDL	775	1080	928	14%	1141	1020	11%	61	92	-3%
Total	1383	1908	1637	14%	1990	1810	9%	82	173	-5%

1.11. On a like-for-like basis with Initial Proposals, excluding costs recovered through reopeners or logging up mechanisms, the overall effect of our updated cost assessment is to increase the allowance for CE NEDL by £84m, or 12 per cent. When we take into account the proposals in the September update for certain areas of costs to be recovered through a logging up or a reopener mechanism the overall effect of our updated cost assessment is to increase the allowance we set out in Initial Proposals by £81m or 11 per cent.

1.12. On a like-for-like basis with Initial Proposals, excluding costs recovered through reopeners or logging up mechanisms, the overall effect of our updated cost assessment is to increase the allowance for CE YEDL by £95m, or 10 per cent. When we take into account the proposals in the September update for certain areas of costs to be recovered through a logging up or a reopener mechanism the overall effect of our updated cost assessment is to increase the allowance we set out in Initial Proposals by £92m or 10 per cent.

1.13. We do not intend to carry out any further work on the cost allowances other than to update our work on RPE forecasts, if appropriate. However, the Authority may decide, having heard the representation of the DNOs, the team and others, that further changes should be made in our Final Proposals.

1.14. I trust that this letter and its appendices provide you with a clear account of the changes we have made to our cost and revenue analysis since Initial Proposals. Do not hesitate to contact me or members of my team should you require further explanation.

Yours sincerely,

Rachel Fletcher
Partner, Distribution

Appendix 1 - Operational cost analysis

1.15. This Appendix sets out our updated assessment for Operational Costs. Over the last few weeks we have worked through the comments and issues raised after the publication of Initial Proposals, we have considered additional information that the DNOs have provided, including updates to their FBPQs, and we have undertaken the work signalled in Initial Proposals, to revise our adjustments for insourcing and outsourcing. We have addressed all of the errors and omissions that DNOs have pointed out to us and have taken significant steps to address many of the matters raised with us in August and September.

1.16. Our analysis of the Traffic Management Act (TMA) is unchanged from that set out in the September update document. Tables 4 and 5 provides an update of our baselines for Operational Costs for your DNOs together with a comparison with Initial Proposals.

Table 4: Summary Comparison of Current View to Initial Proposals - CE NEDL

	DPCR4 Updated	Initial Proposals (IP)			October Letter			Difference October	
		DPCR5 Forecast	Ofgem Baseline	Difference	DPCR5 Forecast	Ofgem Baseline	Difference	DPCR5 Forecast	Ofgem Baseline
	£m	£m	£m	£m	£m	£m	£m	%	%
Network Operating Costs	121	112	116	4	126	142	17	13%	23%
Closely associated Indirects	101	102	91	-11	102	94	-8	0%	3%
Business Support Costs	87	84	81	-3	84	85	1	-0%	5%
Non-Operational Capex	22	23	23	-0	29	41	12	22%	78%
Workforce renewal	1	7	4	-3	17	12	-5	136%	175%
Traffic management costs	1	5	1	-4	1	1	-0	-76%	3%
Total	**334**	**333**	**316**	**-16**	**358**	**375**	**17**	**8%**	**19%**

Table 5: Summary Comparison of Current View to Initial Proposals - CE YEDL

	DPCR4 Updated	Initial Proposals (IP)			October Letter			Difference October	
		DPCR5 Forecast	Ofgem Baseline	Difference	DPCR5 Forecast	Ofgem Baseline	Difference	DPCR5 Forecast	Ofgem Baseline
	£m	£m	£m	£m	£m	£m	£m	%	%
Network Operating Costs	182	172	180	8	196	188	-8	14%	4%
Closely associated Indirects	113	117	115	-2	117	111	-6	1%	-3%
Business Support Costs	100	96	101	5	96	102	5	-	0%
Non-Operational Capex	22	28	25	-3	30	38	8	6%	50%
Workforce renewal	1	11	6	-4	28	22	-6	164%	259%
Traffic management costs	2	10	2	-8	2	2	-0	-76%	27%
Total	**419**	**433**	**430**	**-4**	**469**	**462**	**-7**	**8%**	**8%**

1.17. The Ofgem baselines have increased for both of the CE DNOs; by £59m (19 per cent) for CE NEDL and by £32m (8 per cent). The key areas for increases in both DNOs are Non-Operational Capex and Workforce Renewal. The only area where baselines have reduced are for Indirects closely associated with direct work for CE YEDL of £4m.

1.18. The following sections detail the material changes in our analysis since Initial Proposals and where possible we have identified the material impact on allowances.

Material Changes in analysis outside of the benchmarking

1.19. The following tables show the changes in Ofgem baselines for operational costs. The table lists those areas with the most material changes and shows the overall change resulting from the other analysis undertaken, including the benchmarking.

Table 6: Specific baseline changes since Initial Proposals - CE NEDL

	Change from Initial Proposals (£m)	Change from Initial Proposals (%)
PLUS: STE & Vehicles	11	2%
PLUS: Unmetered Electricity	11	2%
CHANGE: Tree Cutting	0	0%
CHANGE: IT Costs	11	2%
CHANGE: Wayleaves	1	0%
CHANGE: TMA	0	0%
CHANGE: Workforce Renewal	8	2%
MOVEMENT FROM OTHER ISSUES	**42**	**9%**
Movement from other analysis	17	4%
TOTAL MOVEMENT	**59**	**13%**

Table 7: Specific baseline changes since Initial Proposals - CE YEDL

	Change from Initial Proposals (£m)	Change from Initial Proposals (%)
PLUS: STE & Vehicles	12	3%
PLUS: Unmetered Electricity	18	4%
CHANGE: Tree Cutting	0	0%
CHANGE: IT Costs	8	2%
CHANGE: Wayleaves	2	0%
CHANGE: TMA	0	0%
CHANGE: Workforce Renewal	16	3%
MOVEMENT FROM OTHER ISSUES	**57**	**12%**
Movement from other analysis	-25	-5%
TOTAL MOVEMENT	**32**	**7%**

1.20. The overall £91m increase in Ofgem baselines for the CE DNOs relates almost equially to the inclusion of Vehicles and Small Tools & Equipment, Unmetered Electricity, Workforce Renewal and the results from our IT consultant's work. From our other analysis CE YEDL shows a £25m reduction in baselines while CE NEDL shows a £17m increase.

'Vehicles & Transport', 'Small Tools & Equipment' and 'Plant & Machinery'

1.21. We developed our methodology to ensure that these costs were not influenced in our analysis by procurement decisions, i.e. the choice of whether to buy or lease. We consider it is appropriate that the costs follow the activity which they support. At Initial Proposals we therefore identified the proportion of costs in this area relating to Network Investment and excluded it from our benchmarking analysis.

1.22. Due to an oversight these costs were not included within the Network Investment assessment. This has now been corrected. The additional costs have been included within our baseline figures for Operational Costs to enable comparisons with your forecasts on a like-for like-basis.

1.23. The costs of vehicles and transport, small tools and equipment and plant and machinery relating to network investment have been scaled back by the total percentage adjustment applied to your Network Investment forecasts.

Unmetered Electricity

1.24. The updated FBPQs include data relating to unmetered (substation) electricity forecasts for all of the DNOs. In Initial Proposals we only included allowances for those DNOs that had provided the required information. We have now received the data to allow us to include allowances for all DNOs. We expect this change to have a neutral impact on the DNOs because we have made an equitable adjustment to the losses incentive for those DNOs that have not previously been billed for their electricity usage.

Information Technology

1.25. At Initial Proposals our consultants Mouchel, had not completed their assessment of DNOs' information technology costs. We therefore used the results of our indirect benchmarking analysis to determine the allowances. Mouchel's work is now complete and we have used the consultant's report to set baselines.

Wayleaves

1.26. We have had further discussions with the DNOs in relation to wayleave costs and the impact of changes in the rates payable. We now consider that the DNOs' forecasts are broadly appropriate and have agreed to fund the forecast costs in full in determining baseline allowances. The impact has been to increase baselines for the DPCR5 period for CE NEDL by £1m and CE YEDL by £ 2 m compared to Initial Proposals.

Workforce Renewal

1.27. We have updated the workforce renewal analysis to incorporate the DNOs' latest forecasts. The DNOs have argued that we should be taking into account gross rather than net capex in assessing workforce renewal associated with growth in costs. We do not consider this to be appropriate. Net capex is appropriate as workforce renewal costs associated with sole use assets or the customer funded element of shared work should be recovered through connection charges. We are no longer constraining any DNOs' network operating cost baselines to their own forecasts so our adjustments to take account of costs already included in the regressions are corrected. We have now applied the full consequential adjustments to workforce renewal growth costs relating to the cuts in the network investment and operational costs.

Changes in the data provided by the DNOs

1.28. Since Initial Proposals we have allowed DNOs to resubmit their FBPQs to update their forecasts to reflect additional data available to them and to ensure that the information provided is consistent across the industry.

1.29. Although the net change in the overall DNOs' forecasts is only £9m they range from an increase of £36m to a decrease of £37m. In addition to the changes noted above, DNOs amended data to:

- correct errors in the attribution of fault cost recoveries (EDFE),
- include some costs reported by the DNOs as atypical in 2008-09 into our analysis to ensure consistency with previous years. This data was not available at Initial Proposals.
- remove some remaining pension related costs (pensions admin and PPF levy) included within the costs submitted by the DNOs and not seperately identified.

Refinements to our analysis

Outsourcing adjustment

1.30. A key change in our analysis since Initial Proposals has been the treatment of differences in outsourcing. We have replaced the interim IDT adjustment for the EDFE DNOs with an adjustment to account for the indirects previously excluded from our analysis due to differing degrees of outsourcing.

1.31. With the co-operation of the ENA and all the DNOs we asked for a submission of data with estimates of the value of both materials and indirect activity type costs containted within the costs reported under contactors. We developed an adjustment based on this information to normalise costs for the different level of outsourcing that these submissions highlighted.

Fault cost drivers

1.32. Some of the DNOs identified an inequity in our approach resulting from inconsistent reporting of fault numbers across the industry. They highlighted that faults not classified to a particular asset category ranged from 2 per cent up to around 30 per cent of the total LV faults. We agreed this appeared to unfairly discriminate against some DNOs and included LV faults with the LV & HV Underground Faults driver. Some DNOs identified that we had not included Severe Weather Event faults in the drivers for the costs we have benchmarked. This has been amended.

Traffic Management Act (TMA) Admin Costs

1.33. We recognised inconsistency in the completion of the admin costs for TMA requirements and have transferred them to Group 2 costs and included them in our benchmarking.

Gross Cost Drivers

1.34. At Initial Proposals we identified that we were including gross cost (i.e. including indirects relating to connections) when determining comparative efficiency scores. This approach was adopted because of concerns over the ability of the DNOs to accurately report the direct work that indirect activities support on a consistent basis. However, at Initial Proposals we did not amend the relevant cost drivers to reflect the gross activity. This has now been amended so that the relevant drivers take into account gross capex.

Setting benchmarks

1.35. At Initial Proposals we introduced a hybrid approach for Network Operating Costs (NOCs) in response to the large range in scores identified in our analysis. We adjusted DNOs that were performing worse than the average down to the average. For DNOs which were performing better than the upper quartile we have moved them to the upper quartile. For DNOs between the average and the upper quartile there was no adjustment to their 2008-09 costs. For DNOs performing worse than the upper quartile level of efficiency we also capped our baselines at the DNO forecasts.

1.36. Given the spread in efficiency results for network operating costs we still consider it is appropriate to apply a differential approach to indirect costs. However, we consider that Initial Proposals' approach potentially disadvantaged both some of the better performers and those with steep decreases in their forecasts relative to other DNOs. We have therefore amended our approach to move all DNOs to the 'upper third' score for NOCs while retaining a movement to 'upper quartile' for indirect costs. We are satisfied that this approach is fair because of the different range in scores in both those areas, whereby the range for indirects is notably smaller than for NOCs.

Rolling forward benchmarked Indirect costs to DPCR5 baselines

1.37. Some DNOs highlighted that their 2008-09 capex work include significant major schemes that do not require large additional indirect costs to be incurred. Using the 2008-09 capex costs as a starting point for rolling forward indirects would therefore penalise them. We have used a weighted average capex over four years for the starting point for rolling forward indirect costs rather than just the 2008-09 costs.

Statistical Tests

1.38. We have had further discussions with our academic advisor relating to the use of statistical tests on our analysis. These discussions have resulted in a change to the model specification test - the RESET test. The version of the test reported at Initial Proposals was not robust to heteroscedasticity. We have therefore adopted a Wald test which is robust to heteroscedasticity. The version of the test used checks whether the squared fitted values from a regression are statistically significant when they are included as an additional driver in the original regression. In a number of our regressions this additional term has been found to be statistically significant which might suggest an issue with the specification of our models. We think that the results of our analysis remain robust and fit for purpose for the following reasons:

- The test only indicates whether the squared fitted values have any explanatory power, it does not provide any further information as to whether/how a model should be modified. Moreover, it does not answer the question of whether there exists a more appropriate model with additional/alternative cost drivers. We have estimated a series of regressions for each category of costs with a range of possible cost drivers to explore this avenue. The results of these models broadly support each other and we think it appropriate to continue with our current approach.
- We believe that the log-log functional form of our models makes economic sense. This functional form suggests that a 1% increase in the cost driver leads to a constant percentage increase in costs. We do not think it appropriate to deviate from this assumed relationship.

1.39. The results from our other statistical tests support this view:

- We have not found any problems with the distribution of the residuals from our model.
- We have not found any statistical evidence to suggest that the slopes on the cost drivers are not constant over time.
- Heteroscedasticity has been detected in a number of models. This finding affects the standard errors (we have corrected these using a robust estimator) and the use of F tests (we have used the heteroscedasticity-robust Wald version of the test statistic). The estimated coefficients which we rely upon for our efficiency assessment remain unbiased.
- Our cost drivers and models have been found to be statistically significant. This suggests that the drivers we have included in our models have strong explanatory power.
- We have found some outliers in our analysis but this is unsurprising (given the sample size in our models one would expect there be outliers detected) and does not effect the robustness of our models as we have no strong expectation for the residuals to follow a particular distribution.

1.40. In addition to these points we have recognised that the econometric models cannot provide robust efficiency assessments in isolation. We have used regulatory discretion to make adjustments where we think appropriate so that the data are comparable and so that DNO specific factors are taken into account. We have also recognised that the unexplained costs in our regressions might not all be due to inefficiency and for this reason we have benchmarked against the upper quartile or below rather than the frontier.

Real price effects (RPEs)

1.41. We have not changed our underlying RPE assumptions for this letter, i.e. we are still relying on the assumptions provided in CEPA's April 2009 report. However, we have asked CEPA to review the responses to their earlier work and to update their forecasts taking account of the responses and the most up-to-date information available. In addition, we are planning to review the inclusion of materials costs within contractors' costs by some DNOs and make adjustments as appropriate. The only changes in approach to that used at Initial Proposals (DNOs have been sent a worked example of this) are as follows:

- We have corrected a linking error in row 137 of the worked example which calculates a price index for "Materials (opex)" – this now links to row 127 rather than row 121.
- We have also removed pensions from the RPEs calculations because pensions costs are not included within these allowances. The price indices for the different building blocks in rows 145 to 150 are now calculated using the following structure: "(labour weight*labour price index + contractors weight * contractors price index + [other input price indices multiplied by their weights – excluding pensions])/(1- pensions weight)".

Other

In addition to the points included above we have also:

- Amended the adjustment for the SP Manweb interconnected network
- Reviewed our analysis of dismantlement costs and amended our baselines to take account of specific dismantlement projects identified by some DNOs
- We have amended the capex indexation for indirects to divide capex increases by three rather than four.
- We have amended direct cost drivers for double counting of some costs.

Changes we have not made

1.42. We have maintained our position of running our analysis both with the Labour/Contractor Regional Adjustment across all the DNOs and for only the LPN region. Our overall view takes account of both.

1.43. We have maintained our position of running our analysis both with Non-Load Cable Replacement and without. Our overall view takes account of both.

1.44. We do not agree with the approach of applying the results of analysis to a certain category of costs to the results of different analysis. We have therefore not applied the results of the benchmarking of faults to any of the fault categories excluded from the benchmarking.

1.45. Additional obligations under DPCR5. We have asked the DNOs to provide us with estimates of the additional costs they forecast they will incur in meeting new obligations. We have now received further submissions from the DNOs but these were not received in time for consideration within this letter.

1.46. One of the DNOs identified that we had not made any adjustment to exclude pensions from Island Generation costs. We have not amended our analysis due to the low materiality of this issue.

1.47. Some DNOs expressed views that the analysis should not be split between NOCs and Indirects because of boundary issues and the impact of insourcing vs. outsourcing. We have improved our analysis by the inclusion of an insoursing/outsoursing adjustment. Our view is that we apply different analysis on a pragmatic basis and where we identify good reasons for a different approach we do so.

Appendix 2 - Network investment

Areas of network investment covered by this letter

1.48. This letter provides an update on all areas of network investment that were not consulted on in the September letter. This includes:

- Diversions,
- General reinforcement,
- Fault levels,
- Asset replacement,
- Quality of Service (QoS),
- Legal and safety (excluding raising mains, CNI and Blackstart),
- IT&T (excluding BT21CN), and
- Environment (excluding losses).

1.49. Our proposals for the areas covered by the September letter remain unchanged for the purposes of this letter.

Summary of key points common to all DNOs

Diversions

1.50. Our initial proposals for the diversions allowed for an increase of 50 per cent on DPCR4 levels of expenditure for conversions of wayleaves to easements and injurious affection payments. The proposals did not consider that there was a need for increased expenditure for diversions due to wayleave terminations or diversions for highways.

1.51. In response to these proposals some DNOs indicated that they believe there is strong evidence for even greater cost increases in their licence areas for conversions of wayleaves to easements and injurious affection. To address these comments we have carried out a more detailed analysis which recognises the different levels of agent activity across the licensed areas. We have analysed the trend in actual costs over the first four years of DPCR4 for each individual DNO and extrapolated this to determine an allowance, limited to the DNO's forecast.

1.52. A number of DNO also challenged our approach to analysing allowances for diversions due to wayleave terminations or highways. Except where a DNO has been able to provide evidence of large one-off projects with a high degree of certainty, and where the historical average does not include projects of that magnitude, we have maintained our position of limiting our baseline to the historical levels of spend.

General Reinforcement

1.53. Several DNOs have raised concerns with our assessment of the required volume of 132kV and EHV general reinforcement. As explained at various meetings and discussions at working level, our primary method of assessment was based on reviewing individual schemes taking into account the DNO's forecast load growth and the substation firm capacity (N-2 or group capacity where appropriate).

1.54. Further supporting information was requested via the question log where an initial review indicated an issue with the DNO's forecast. This was reviewed by both Ofgem and PB Power to form a final view and where appropriate an adjustment to the forecast was made.

1.55. Since initial proposals DNOs have undertaken a detailed reconciliation between their FBPQ and the Load Index (LI) output measure. We have now reviewed the LI for each of the substations or groups that were subject to an Ofgem adjustment in IP. Where appropriate we have updated our baseline view in line with the LI analysis.

1.56. In order to focus the discussion at the higher level we do not intend to reopen the detailed analysis.

1.57. We maintain our position that where our analysis indicates that a DNO has high unit costs for undertaking general reinforcement it is appropriate to make an adjustment to the DNO's forecast. In carrying out this analysis we are placing most weight on the benchmarking of new build unit costs submitted in FBPQ table C2 and the results of our NLRE unit cost benchmarking. As explained in IP we have not undertaken a full update of the £m/MVA capacity model.

1.58. In line with the policy approach for High Value Projects (HVP), schemes greater than £15m in value have been excluded from the volume and unit cost assessment and will be subject to a separate mechanism. Pending further development of the mechanism, the unadjusted DNO forecasts for HVPs have been included in our updated baselines.

Fault Levels

1.59. Our initial proposals for fault level expenditure were based on evidence provided by the DNOs of existing fault level issues and the network investment solutions and costs to mitigate these. In most cases our proposed allowances were in line with the DNO forecasts. We do not propose to update our methodology for this area of costs.

Asset Replacement

1.60. Following publication of our initial proposals several DNOs raised concerns about the scope of work being included in the modelled and non-modelled forecasts for asset replacement. We have addressed these concerns by allowing DNOs to reconcile their forecast costs in a spreadsheet format equivalent to that which was used in calculating our initial proposals. This reconciliation has allowed all DNOs to provide their view of the split between modelled and non-modelled costs and it has been used in setting our updated baseline view.

1.61. The reconciled forecasts have allowed us to carry out a more in-depth analysis of non-modelled costs, reviewing each area on its merits and taking a view as to the appropriate level of baseline allowance.

1.62. Several DNOs have raised concerns over our use of a benchmarked unit cost and our use of the DNOs' unit costs where they are lower than the benchmark. We continue to consider that use of the median unit cost as a default is appropriate, adjusted for specific issues and outliers where these can be demonstrated. Our updated unit cost schedule has been saved on the extranet. The schedule shows how the unit cost has been calculated and any movements since initial proposals. We consider that our analysis is now even more robust having taken into account the DNOs' reconciliation of costs.

1.63. We consider that our use of the lower of the DNO's and the benchmarked unit cost remains appropriate. Where costs relate to completely separate activities we see no reason to allow high and low unit costs to offset each other as we think this would provide an allowance greater than that required by an efficient DNO. In areas where cost allocation issues may arise then it may be appropriate to allow high unit costs in one area to offset low unit costs in another to ensure that "cherry picking" does not arise. To date no DNOs have been able to demonstrate that such issues exist except for costs relating to undergrounding and replacement of LV mains and services.

1.64. For LV underground mains we have updated our analysis to take account of the higher cost of replacing an existing underground main (due to the costs of jointing to the existing service) than undergrounding an LV overhead line (where the costs of the services are allocated to the new underground service).

1.65. Individual movements and adjustment for unit costs are discussed in the "Key company specific points" section below.

1.66. Our modelling methodology for asset replacement remains consistent with the approach taken for initial proposals. We have now updated the modelling to take account of actual volumes of replacement and the asset age profiles as reported for the year 2008-09. As a result, our projected replacement volumes for the DPCR5 period are now based on 5/6ths of the forecast volumes to the end of DPCR5. Our modelled view has been updated in line with the results from this model.

1.67. In almost all cases the calculated lives have been consistent between the 07/08 model and updated 2008-09 model. Where the model volumes have been used to set our baselines (i.e. where the DNO was unable to provide sufficient supporting information) rerunning the model has not had a material impact. Individual volumes movements are discussed in the "Key company specific points" section below.

QoS

1.68. We maintain that our policy position set out in both the May consulation paper and in Initial Proposals that the incentive rate should drive DNO decision making about expenditure to improve quality of supply performance in DPCR5 is still appropriate. As such we are not proposing to allow any up-front allowances for either CI or CML improvements in DPCR5.

1.69. Given customer priorities and willingness to pay from our customer research for DPCR5 we are still of the view that no specific expenditure should be allowed for network resilience. We have also taken into account the significant increase in expenditure devoted to tree cutting to comply with the revised ESQCR regulations that were intended to improve network resilience and see this as another reason not to allow additional expenditure in this area.

Legal and safety (excluding rising mains, CNI and blackstart)

1.70. We have received comments from several DNOs relating to the analysis carried out for ESQCR safety clearances, and in particular adjustments that were made to account for the proportion of network assets requiring remedial action. As a result we have gathered more disaggregated information about the type, length and unit costs of work required, categorising work against replacement of a single service (LV), one, two or three spans of OHL and four or more spans of OHL. We gathered this information for:

- Undergrounding of LV and HV overhead lines with vertical clearance issues,

- Rebuilding of LV and HV overhead lines with vertical clearance issues,
- Undergrounding of LV and HV overhead lines with horizontal clearance issues, and
- Reconductoring of LV and HV overhead lines with horizontal clearance issues.

1.71. Using this information we have carried out more detailed benchmarking of costs. Our updated unit cost schedule for ESQCR clearance issues has been saved on the extranet. Analysis of the unit costs presented by the companies does not reveal a clear distinction between unit costs of replacing a span of overhead line, when the total length of replacement is one, two or three spans. We have combined these categories in our benchmarking.

1.72. For those DNOs replacing four or more spans of LV overhead line with covered conductor we consider that the unit cost should be equivalent to the benchmarked unit cost derived for asset replacement.

1.73. We have continued to apply an adjustment factor to normalise unit costs for different average numbers of services per pole across the distribution networks. The normalised unit costs are benchmarked to the mean.

1.74. Our proposed reductions to the DNO's forecasts are based on unit costs rather than volume of work, in recognition that the volumes of work forecast are as agreed with the Health and Safety Executive (HSE).

1.75. Several DNOs have also questioned the robustness of the benchmarking carried out for site security costs. They consider that increasing but regionally dependent levels of criminal activity mean that the benchmarking carried out is inappropriate. We believe that the DNOs are best placed to assess trends in the level of such activity in their areas and that their forecasts are more robust than the simple benchmarking carried out for initial proposals. We propose baseline allowances equal to the DNOs' forecasts.

Operational IT&T (excluding BT21CN)

1.76. As previously discussed this area of expenditure was subject to a high level expert review carried out by PB Power. We do not propose to reassess this expenditure across the industry.

Environment (excluding losses)

1.77. In all cases our proposed allowances were in line with the DNO forecasts. We do not propose to update our methodology for this area of cost.

Key company specific points

Asset Replacement

1.78. Table 8 shows the updated results of our assessment of asset replacement requirements. This includes:

- the updated split between modelled and non-modelled costs based on the further information provided by the DNOs,
- our updated benchmarked unit costs (a unit cost schedule is provided as a spreadsheet appendix to this document), and
- the results of rerunning the replacement model using 08/09 age profiles and actual replacement volumes.

Table 8 Updated Asset Replacement Baseline

CE_NEDL	Initial Proposals				October Update			
DNO £m (07/08 prices)	DPCR5 Forecast	Baseline	Reduction from DNO Forecast	Reduction (%)	DPCR5 Forecast	Baseline	Reduction from DNO Forecast	Reduction (%)
Modelled								
Total Modelled	197.8	162.3	35.5	18.0%	173.9	161.4	12.5	7.2%
Unit Cost			31.6				12.5	
Volume			4.0				0.0	
Overhead Pole Lines	57.9	52.7	5.2	9.0%	57.5	55.9	1.6	2.8%
Substation Civils	14.0	14.0	0.0	0.0%	14.0	14.0	0.0	0.0%
Non Modelled	9.5	7.6	1.9	20.0%	33.8	33.3	0.6	1.7%
Total	279.2	236.6	42.7	15.3%	279.2	264.6	14.7	5.3%

CE_YEDL	Initial Proposals				October Update			
DNO £m (07/08 prices)	DPCR5 Forecast	Baseline	Reduction from DNO Forecast	Reduction (%)	DPCR5 Forecast	Baseline	Reduction from DNO Forecast	Reduction (%)
Modelled								
Total Modelled	247.7	197.7	50.0	20.2%	221.3	200.3	21.0	9.5%
Unit Cost			44.4				21.0	
Volume			5.6				0.0	
Overhead Pole Lines	56.6	49.5	7.1	12.5%	56.3	50.0	6.3	11.2%
Substation Civils	18.6	18.6	0.0	0.0%	18.6	18.6	0.0	0.0%
Non Modelled	7.3	5.8	1.5	20.0%	34.0	34.0	0.0	0.0%
Total	330.2	271.7	58.5	17.7%	330.2	303.0	27.3	8.3%

1.79. Based on further discussions and taking account of the overall quality of CE's asset management we have removed the relatively small adjustment for the replacement of fluid filled cables.

1.80. We have also made adjustments to the modelled/non-modelled split provided by CE. We have included LV breach joints within the modelled costs for replacement of LV mains consistent with our understanding of industry practice. For HV transformers and switchgear we have added back a percentage of "proportion of substation costs" as no justification has been provided as to why these costs should be fully excluded from the model, and our understanding is that these are included within other DNOs' modelled costs. For the same reason we have added back a percentage of "Other - Step bolts, steelwork, notices, ACGs, switching etc" for EHV and 132 kV OHL refurbishments.

1.81. Our initial proposals for operational IT and T were based on the DNO's June FBPQ submissions. You have since submitted an updated FBPQ which includes £13.7m of forecast costs which were not previously included. We have conducted a high level review of your investment proposals and consider that they are justified. In coming to this view we have considered efficient spend as determined by PB Power for the other DNOs. We recognise that your previous submission did not include the same scope of work and performance considerations as other DNOs.

Updated Network Investment Baseline

1.82. The table below contains the updated Network Investment baselines.

Table 9 Updated Network Investment Baseline – CE Electric

CE_NEDL		Initial Proposals			October Update			Change (October - IP)		
£m (07/08)	DPCR4 actuals	DPCR5 Forecast	Baseline	Reduction (%)	DPCR5 forecast	Baseline Updated	Reduction (%)	DPCR5 forecast	Baseline	Reduction
Core (Ex-ante)										
Demand Connections	11.0	20.0	20.0	0.0%	20.0	11.0	45.0%	0.0	-9.0	45.0%
Diversions	15.9	19.7	15.2	22.7%	19.7	16.9	14.0%	0.0	1.7	-8.7%
Reinforcement	61.2	56.4	56.3	0.0%	56.4	56.4	0.0%	0.0	0.0	0.0%
Fault Levels	1.0	8.9	8.9	0.0%	8.9	8.9	0.0%	0.0	0.0	0.0%
Asset Replacement	154.9	279.2	236.6	15.3%	279.2	264.6	5.3%	0.0	28.0	-10.0%
Operational IT&T	0.4	0.4	0.4	0.0%	5.1	5.1	0.0%	4.6	4.6	0.0%
Legal and Safety	8.3	8.7	8.0	7.9%	8.7	8.7	0.0%	0.0	0.7	-7.9%
Total	252.7	393.4	345.5	12.2%	398.0	371.6	6.6%	4.6	26.0	-5.5%
Non Core (Ex-ante)										
BT21CN	0.0	2.3	2.3	0.0%	2.3	2.3	0.0%	0.0	0.0	0.0%
Flooding	0.6	2.5	2.4	4.9%	3.2	1.8	45.0%	0.7	-0.7	40.0%
QoS (IIS)	15.3	2.4	0.0	100.0%	2.4	0.0	100.0%	0.0	0.0	0.0%
QoS (Non IIS)	0.7	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
Environmental	1.5	1.2	1.2	0.0%	1.2	1.2	0.0%	0.0	0.0	0.0%
Losses	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
Total	18.1	8.5	5.9	30.1%	9.1	5.3	42.3%	0.7	-0.7	12.2%
Total (Ex-Ante)	270.7	401.8	351.5	12.5%	407.1	376.8	8.0%	5.3	25.4	6.7%
Non Core (Reopener/logging up)										
HILP	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
CNI security	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
Black Start Capability	0.0	0.0	0.0	0.0%	3.7	0.0	100.0%	3.7	0.0	100.0%
Rising mains	0.0	4.0	4.0	0.0%	4.0	1.6	59.1%	0.0	-2.4	59.1%
Total	0.0	4.0	4.0	0.0%	7.7	1.6	78.6%	3.7	-2.4	78.6%
Total	**270.7**	**405.9**	**355.5**	**12.4%**	**414.8**	**378.5**	**8.8%**	**8.9**	**23.0**	**-3.7%**

CE_YEDL		Initial Proposals			October Update			Change (October - IP)		
£m (07/08)	DPCR4 actuals	DPCR5 Forecast	Baseline	Reduction (%)	DPCR5 forecast	Baseline Updated	Reduction (%)	DPCR5 forecast	Baseline	Reduction
Core (Ex-ante)										
Demand Connections	9.8	28.7	28.7	0.0%	28.6	14.2	50.3%	0.0	-14.4	50.3%
Diversions	28.2	44.5	31.3	29.7%	44.5	39.5	11.3%	0.0	8.2	-18.4%
Reinforcement	49.3	62.7	62.7	0.0%	62.7	62.7	0.0%	0.0	0.0	0.0%
Fault Levels	2.7	14.1	14.1	0.0%	14.1	14.1	0.0%	0.0	0.0	0.0%
Asset Replacement	217.5	330.2	271.7	17.7%	330.2	303.0	8.3%	0.0	31.3	-9.5%
Operational IT&T	3.7	0.4	0.4	0.0%	9.4	9.4	0.0%	9.0	9.0	0.0%
Legal and Safety	19.3	23.0	16.9	26.4%	23.0	18.5	19.6%	0.0	1.5	-6.7%
Total	330.5	503.7	425.8	15.5%	512.6	461.4	10.0%	8.9	35.6	-5.5%
Non Core (Ex-ante)										
BT21CN	0.0	3.2	3.2	0.0%	3.2	3.2	0.0%	0.0	0.0	0.0%
Flooding	2.1	7.8	6.9	10.8%	29.6	29.0	2.0%	21.8	22.1	-8.8%
QoS (IIS)	18.1	7.6	0.0	100.0%	7.6	0.0	100.0%	0.0	0.0	0.0%
QoS (Non IIS)	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
Environmental	1.6	1.9	1.9	0.0%	1.9	1.9	0.0%	0.0	0.0	0.0%
Losses	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
Total	21.8	20.5	12.1	41.2%	42.3	34.1	19.3%	21.8	22.1	-21.8%
Total (Ex-Ante)	352.3	524.2	437.9	16.5%	555.0	495.5	12.0%	30.7	57.6	-27.3%
Non Core (Reopener / logging up)										
HILP	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
CNI security	0.0	0.0	0.0	0.0%	0.0	0.0	0.0%	0.0	0.0	0.0%
Black Start Capability	0.0	0.0	0.0	0.0%	9.0	0.0	100.0%	9.0	0.0	100.0%
Rising mains	0.2	5.9	5.9	0.0%	5.9	2.4	59.1%	0.0	-3.5	59.1%
Total	0.2	5.9	5.9	0.0%	14.9	2.4	83.9%	9.0	-3.5	83.9%
Total	**352.4**	**530.1**	**443.8**	**16.3%**	**569.8**	**497.9**	**12.6%**	**39.8**	**54.1**	**-3.7%**

Appendix 3 - Pulling costs together

1.83. This section reproduces the information presented within Section 7 of the "Allowed revenue – Cost Assessment" document published at initial proposals. The figures presented reflect the proposals made in the September update and the changes made in this letter to our earlier analysis. We have used the same IQI matrix presented at Initial Proposals.

1.84. We have included a table at the end of this section setting out the relevant items that are included within each expenditure category by detailing the relevant lines from the T0 model input sheet from the FBPQs.

Revised IQI tables

1.85. Tables 10 and 11 below present the inputs and outputs from the IQI. Since initial proposals, the following expenditures have been added to the IQI: flooding, BT21st Century, and traffic management admin costs. The reasons for these changes are set out below:

- Flooding was only excluded from the IQI at Initial Proposals due to an error. Table 19.1 of the "Incentives and obligations" document set out that we intended to include these costs within the IQI.
- We have now undertaken a cost assessment of BT21st Century costs and believe there is sufficient certainty surrounding these costs for them to be included within the IQI.
- Traffic management admin costs have been added to the regressions of Group II indirects. This was done for two reasons: some DNOs had not removed these costs from their historical EMCS figures and thus were already included, and for the DNOs that did extract these costs there was a significant variation between them suggesting that the same activities were not being reported.

Table 10 – Inputs to the IQI mechanism (£m 2007-08 prices)

	DNOs' FBPQ forecasts				Ofgem's baselines				
	Network investment	Network operating costs	Closely associated indirects	Total	Network investment	Network operating costs	Closely associated indirects	Total	Ofgem's baselines as a percentage of the DNOs' forecasts
CE NEDL	401.3	142.1	102.0	645.3	371.3	154.0	93.4	618.8	96%
CE YEDL	548.6	223.5	117.4	889.5	489.6	210.1	111.2	810.9	91%

Table 11 – Outputs from the IQI (£m 2007-08) prices

	DNOs' forecasts	Allowed expenditure	Additional income	Incentive rate
CE NEDL	645.3	625.4	9.3	46%
CE YEDL	889.5	830.6	12.3	46%

Costs outside the IQI

1.86. Table 12 below presents our revised cost assessments for expenditure outside the IQI. Flooding, BT 21st Century, and traffic management admin costs have been removed from this category since Initial Proposals for the reasons stated above.

Table 12 – Cost allowances for expenditure outside the IQI (£m 2007-08 prices)

	Business support costs	Non-operational capex	Network investment (not in the IQI)	TMA costs	RPEs	Total	Allowances as a percentage of the DNOs' forecasts
CE NEDL	85.3	40.9	1.6	1.0	26.5	155.4	76%
CE YEDL	101.6	37.6	2.4	2.0	33.4	177.0	70%

Revised totex allowance tables

1.87. The table below brings together the cost components presented above and shows the overall change since Initial Proposals.

Table 13 – Total price control allowances (£m 2007-08 prices)

	Expenditure allowance	IQI additional income	Total	Change in total since IP	Ofgem's allowances as a percentage of the DNOs' forecasts
CE NEDL	780.8	9.3	790.1	81.4	93%
CE YEDL	1007.6	12.3	1019.9	91.8	89%

Definitions of the different cost categories

1.88. The table below details the rows from the T0 model input sheet of the FBPQs for each of the cost categories presented above.

Table 14 – Definitions of cost categories

Category	Rows in T0
Network investment (in the IQI)	93-99, 102-105
Network operating costs	86-89, 107
Closely associated indirects	90
Business support costs	91
Non-operational capex	92
Network investment (not in the IQI)	100-101
TMA	106
RPEs	108-111

Appendix 4 - Financial issues

1.89. The focus of this appendix is the correction of errors, omissions and unintended consequences in the initial proposals numbers. A number of issues raised by DNOs have therefore not been considered at this stage. These include:

- the speed of money (capitalisation ratios),

- capital allowances – both common allocation proportions and use of opening tax pools, and
- the tax trigger

1.90. We understand the nature of your concerns on these points and will consider these prior to Final Proposals.

1.91. Since Initial Proposals, we have changed the calculation of pensions costs to correct for errors and omissions. We have not changed our treatment of pensions costs or prejudged the outcome of our consultation on this matter. We will publish our "minded to" position on pensions policy for DPCR5 in mid October.

1.92. In order to reflect current market conditions we have made adjustments to the deficit recovery payments as set out in more detail below. The updated allowances are still a "marker" position and will be superceded by our third Price Control Pension Principle Consultation which will set out our minded to position for DPCR5.

1.93. The changes that we have made to our financial modelling are set out below.

Network Rates

1.94. We have based the updated figures on the information received from DNOs setting out the latest view on rates going forward. This has resulted in reductions for most DNOs. In some cases these are quite significant.

Pensions

1.95. We have updated our modelling of ongoing pension costs for the June FBPQ, made adjustments for excluded services and reduced costs by a scaling factor. The scaling factor is set to equal the reduction in expenditure made following the benchmarking analysis as per table 7.4 in the Initial Proposals Outputs document (94/09) as updated for the latest view from the costs and outputs team (but excluding the uplift in that calculation for IQI additional income). At Initial Proposals we used the IQI factors as a marker, pending review.

1.96. For deficit recovery payments we have taken the repayment schedule from the June FBPQ, adjusted for changes in asset value since March (a 28.5 per cent reduction in deficit as shown in the August 7800 Index compiled and published by the Pension Protection Fund) and then applied our latest view of the regulatory fraction (including movements in ERDCs).

1.97. The adjustment for asset values since March has been made to recognise that the March valuation information on which the June FBPQ was based was at the low point for the year and is not representative of current market conditions.

1.98. Regulatory fractions have been updated in the light of discussions since and the double application of the regulation fraction that was included in IP has been removed.

1.99. ERDCs have been updated to reflect the notional payments made over DPCR4.

1.100. The true-up has also been updated to reflect responses to the initial methodology.

1.101. More detail on the corrected methodology is set out in annex 1.

1.102. The updated allowances are still a "marker" position and will be superceded by our third Price Control Pension Principle consultation which will set out our minded to position for DPCR5.

Taxation

1.103. We have made changes to the opening tax pools from the amended closing positions as advised by DNOs (taking account of accelerated first year allowances in 2009-10). We have also updated the percentage allocations where where slightly amended tax pool allocations have been received.

RAV Additions

1.104. We have made changes to correct the treatment of the regulatory fraction, and to incorporate the 2008-09 RRP submission and the updated forecast 2009-10 computation. We have also corrected the adjustment for the ESQCR reopener to remove the inefficiencies identified in the respective decision letters.

Table 15 Summary of DPCR4 RAV additions

£m 2007-08	Opening RAV at 1 April 2005	Additions	Depreciation	Closing RAV 31 March 2010	Under-grounding adjustment	Opening RAV 1 April 2010
CN West	1,124.5	740.0	(486.1)	1,378.4	2.9	1,381.3
CN East	1,111.3	712.2	(486.6)	1,336.9	0.9	1,337.8
ENW	1,078.9	584.2	(461.3)	1,201.8	2.8	1,204.6
CE NEDL	695.0	429.3	(300.3)	824.0	2.7	826.7
CE YEDL	941.7	512.6	(398.3)	1,056.0	1.0	1,057.0
WPD S Wales	676.2	271.2	(296.8)	650.6	0.0	650.6
WPD S West	831.5	405.7	(348.1)	889.1	0.0	889.1
EDFE LPN	1,037.3	609.4	(443.5)	1,203.1	0.0	1,203.1
EDFE SPN	719.6	605.5	(318.8)	1,006.2	4.0	1,010.2
EDFE EPN	1,280.1	914.8	(538.8)	1,656.1	1.0	1,657.1
SP Distribution	1,474.0	477.1	(668.9)	1,282.2	0.5	1,282.7
SP Manweb	869.8	580.7	(372.8)	1,077.6	3.3	1,080.9
SSE Hydro	856.4	289.5	(310.4)	835.6	3.9	839.5
SSE Southern	1,574.4	733.3	(653.6)	1,654.1	3.7	1,657.8
Total	**14,270.5**	**7,865.6**	**(6,084.4)**	**16,051.8**	**26.7**	**16,078.4**

Excluded Services

1.105. In our email to each DNO dated 20 August 2009 we indicated our preliminary intended adjustments to allowed revenues for each excluded services category for DPCR5 although these were not reflected in the financial model published with initial proposals. The adjustments are intended to ensure that services are not remunerated twice – through use of system allowed revenue and excluded services charges. Having considered submissions from DNOs we have now amended the adjustments. The revised position is included in the updated financial model.

1.106. Having considered responses to Initial Proposals concerning the competitive market for metering, we are now of the view that metering excluded services should not be subject to an ex-post RAV adjustment nor to the 'reasonableness' stipulation which will apply to other excluded services charges.

1.107. In addition, we are now considering top-up and standby and enhanced system security as non-relevant excluded services such that they will not be subject to an ex-post RAV adjustment in respect of activity levels. These changes will be reflected in final proposals and licence condition drafting.

Use of System Bad Debts

1.108. We have processed the use of system bad debt costs logged up in your RRPs together with the supplementary information submitted in response to our questions. Where the admissibility criteria covered in the response workbooks were met, relevant amounts have been factored into allowed revenues for 2010-11 net of any reported recoveries of amounts previously allowed. At this stage we anticipate that use of bad debts written off or specifically provided for after this point will be considered at DPCR6. For that reason you should continue to keep appropriate records of account activity including compliance with current best practice/DCUSA requirements and record any recoveries against amounts allowed at this stage.

Financial Model

1.109. A number of changes have been made to the model to reflect discussions since IP. These changes are as follows.

- Corrected indexing in 'Tax Solution - Nominal' and 'Price Control Calcs',
- Depreciation decimalisation (from 33.33 years to 33.3 years),
- Corrected handling of ES5 revenue,
- Deferred revenue tax calculation reworked on a straight line basis,
- IBA tax calculation reworked to follow deferred revenue as above,
- Re-linked input sheets where errors were identified post publication (Percentage of capitalisation, purchases of intangible assets and net acquisition / disposal of subsidiaries),
- Corrected forecasts for Low Carbon Networks Fund, introducing forecasts on a per-DNO basis,
- Calculation of average price change over the period corrected,
- Corrected allocation of easements,
- Corrected capitalisation of indirect costs,
- Amended RAV depreciation rate in capex roller for Scottish firms to 38 years while vesting assets being depreciated,
- Amended losses roller - removed profiling,
- Omission of ESQCR figures (from DNO ESQCR Reopener Recovery Responses) amended,
- Omission of DPCR4 trail for Distributed generation amended,
- Improved accuracy of Innovation Fund Revenue,
- Tax allocation percentage corrections (for plant pool, longlife, IBA, etc..)
- Indirect costs related to faults fully capitalised.
- Vesting depreciation period for Scottish firms amended from 21 years to 20 years
- Omission of ENW fair value adjustments (IFRS) amended

1.110. We will issue an update of the financial model separately which will provide more detail on the methodology changes.The following tables detail the changes to revenue and average X since Initial Proposals.

Group : CE	Base price controlled revenue (£m)					Average X
CE NEDL	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	
Initial proposals	£217.36	£222.61	£234.34	£238.76	£243.27	6.99%
October Letter	£228.39	£242.59	£249.93	£261.31	£268.34	6.21%
Change	£11.03	£19.98	£15.60	£22.55	£25.07	-0.78%

Group : CE
CE YEDL

	Base price controlled revenue (£m)					Average X
	2010-11	**2011-12**	**2012-13**	**2013-14**	**2014-15**	
Initial proposals	£269.31	£275.38	£295.63	£298.23	£305.36	5.60%
October Letter	£292.30	£306.99	£316.32	£318.38	£329.37	4.58%
Change	£22.98	£31.61	£20.69	£20.15	£24.01	-1.02%

Annex 1 – Pensions Methodology

Pension Methodology

Calculation of Deficit funding

1.111. The forecast deficit payments made by the licensees is taken from the FBPQ table F7.

1.112. These forecasts have been based on updated valuations as at 31 March 2009, some of which have been projected forward to 31 March 2010. We base allowances on the projected deficit at 31 March 2010. We consider that the 31 March valuations were not necessarily indicative of what the deficit could be based on subsequent movements in market conditions. At this March 2009, the FTSE 100 share index and other indexes were at a low point for the current economic downtown.

1.113. The projected deficit repayments have therefore been reduced by 28.5 per cent to reflect more current market conditions. This percentage reflects the overall rise in the PPF7800 index between March and August of this year. (This index, published monthly by the Pension Protection Fund, estimates changes in the scheme levels of funding, based on scheme valuation data, which has been adjusted to consistent dates on an approximate basis, using changes in market indices for principal asset classes, and the fixed interest and index-linked gilt yields used to value liabilities.) We acknowledge that this index is a general index and not necessarily representative of movements in DNOs pension schemes but is indicative of movements overall.

1.114. The Regulatory Fraction (see below) is then applied to give the distribution element of the deficit that should be funded and these numbers are entered into the financial model.

Regulatory Fraction

1.115. The Regulatory Fraction represents the element of licensees pension deficits which relates to activity of the distribution business (i.e. the licensed business) and which ultimately, under the pension principles, is funded by customers.

1. In principle, we are retaining the DPCR4 position of an 80/20 split as a starting point and will not re-open that settlement, except for EDFE EPN and CE YEDL which were at 100 per cent.

2. Adjustments are then made to take account of scheme restructuring (mergers, bulk transfers in and out) to arrive at a new fraction.

3. This new fraction (or appropriate rate for each year of DPCR4) will apply relevant to the DPCR4 true up. Where schemes have totally restructured and now are limited to distribution employees the allowed proportion will be revised to 100%, subject to a case-by-case review.

4. For schemes which had no allowed proportion in DPCR4, the appropriate fraction has been determined from data provided by the DNO. There has been correspondence with individual licensees regarding their own fractions.

5. Where during DPCR4 schemes have merged or otherwise restructured and for DPCR5, the regulatory fraction will be shown as a percentage of the scheme total. This will mean that it is not possible to directly compare the DPCR4 percentage with that for DPCR5.

6. To this new percentage will be deducted our view of the movements in the unfunded ERDCs from pre 1 April 2004 (see below).

7. For the indicative calculations of deficit funding described above, we have, wherever possible used the new regulatory fraction as determined in the preceding methodology. In some instances, however, this was understating the required funding (for example where companies had already deducted the regulatory fraction from their forecasts).

Early Retirement Deficit Contributions – ERDCs

1.116. In DPCR4, most companies supplied details of amounts relating to employees who had been allowed to retire early but where the company had not paid into the scheme to cover the future cost of these pensions. An adjustment was made to the Regulatory Fraction to reduce deficit funding (meaning the shareholders would in effect need to make good the shortfall).

1.117. These unfunded ERDCs theoretically still exist for DPCR5 in most cases. We accept that, where schemes have subsequently been taken over and scheme deficits paid off at that time this will also include the ERDCs.

1.118. To arrive at the revised numbers we have:

1. Taken the DPCR4 position and rebased using RPI to 2007/08 prices.

2. An adjustment has then been made for companies where the scheme deficit has been cleared, by for example a take-over and subsequent funding in total of the deficit.

3. This revised sum is then rolled forward each year to create a forecast 2010 position by:

    a. adding expected returns (using the cost of capital for DPCR4).

    b. deducting the proportion of the deficit payments that were disallowed in DPCR4. The expected return is used (rather than actual returns) since this is the figure on which the original valuation was based.

4. The resulting values of ERDCs at 2010 are compared to the deficits that are being forecast for 2010 and a percentage is calculated. This is then used to reduce the regulatory fraction.

Example:

ERDC reduction calculation					
	2005/06	2006/07	2007/08	2008/09	2009/10
B fwd	25.0	16.4	17.0	16.7	16.4
Return at cost of capital	1.4	0.9	0.9	0.9	0.9
Deficit Payments (ERDC fraction)	(2.0)	(1.5)	(1.4)	(1.4)	(1.2)
C fwd	24.4	15.9	16.6	16.2	16.1
Deficit Payments (distribution element)	(20.0)	(15.0)	(14.0)	(14.0)	(12.0)
% of deficit reduced for ERDCs in DPCR4	10%				

Normal ongoing service pension contributions

1.119. These are calculated from the FBPQ submissions, from which non funded items are excluded and to which a scaling factor has been applied.

1. The pension element of business support costs is deducted from the total pension costs and computed separately.

2. The pension costs identified as atypical, non-distribution business (including de minimis costs), relevant and non relevant excluded services and sole use connections are all excluded from the level of future funding.

3. An adjustment is made for reconciling items where the company have not been able to explain satisfactorily why the pensions table should show greater costs than those identified in the main FBPQ tables.

4. Some companies have included RPE factors as an uplift to their pension costs. These are allowed pro rata to the value allowed into totex (i.e. the element that applies to non-allowed items is disallowed) and this value forms part of the adjustment shown in (3) above.

5. The resultant total of normal pension costs is then scaled in line with companies cost reductions (using the latest data but equivalent to table 7.4 of the Initial Proposals - document 94/09). The scaling factor reflects the overall reduction in costs which is being made to companies' FBPQ submissions (excluding the IQI additional income, which is a reward to companies and not a cost).

6. The PPF levy and administration costs are allowed subject to a cap on the fixed rate charge of £100k and for the risk based charge £400k per DNO. We have reviewed the actual cash costs of the PPF levy and administration costs in DPCR4 and the projections and compared them across all companies. In general, it is difficult to forecast the likely movements in the Levy and therefore use a reasonable estimate across DNOs. We have also considered whether DNOs D&B Failure Scores are low, indicating perhaps that a company has not done all it could to mitigate the levy and have capped its forecast. The true up mechanism at the next review will address the position if this assumption proves incorrect.

7. After applying a scaling factor to total PPF and administration fee costs the total is allowed pro rata to the ratio of normal allowed pension costs for the distribution business. Part of these costs are assumed to relate to Business Support costs and are therefore deducted from normal pension costs in the proportion of Business Support costs to normal allowed pension costs.

8. Business support costs are allowed less the scaling factor but adding back the Business Support element of the PPF levy (calculated in (7) above).

1.120. See example below:

		2010-11	2011-12	2012-13	2013-14	2014-15	Total
		£m	£m	£m	£m	£m	£m
Total from F7 reconciliation in June FBPQ		9.1	9.6	9.7	10.0	10.0	48.2
Less:							
Business support		(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	(3.0)
Relevant excluded services		0.0	0.0	0.0	0.0	0.0	0.0
Non-relevant excluded services		(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(2.0)
Non-distribution (inc de minimis)		(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(1.1)
Sole use connections		(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(2.1)
Atypical		0.0	0.0	0.0	0.0	0.0	0.0
Less PPF and admin costs adjustment		(0.7)	(0.6)	(0.6)	(0.7)	(0.6)	(3.0)
Less adjustment for reconciling items		(0.4)	(0.3)	(0.3)	(0.4)	(0.3)	(1.7)
Totex		6.4	7.0	7.1	7.2	7.4	35.2
Less scaling factor	96.4%	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)	(1.3)
PPF & Admin costs allowed		0.3	0.3	0.3	0.4	0.3	1.6
Total totex to be funded		6.5	7.1	7.2	7.3	7.5	35.6
Business Support		0.6	0.6	0.6	0.6	0.6	3.0

Pensions true up

1.121. A calculation has been made to restore companies to the position they would have achieved if their actual pension payments had been forecast perfectly in the last price review. The calculation is made on the basic building blocks used with the approach being simplified as far as possible.

1. The calculation takes the actual (including forecast) numbers for DPCR4 and compares them to the allowed funding (all in constant prices). The actual numbers include payments relating to the PPF levy (fixed and risk based) and are those used to populate the RAV additions table. Note: If collected through an addition the normal pension costs these are already within the actual cash payments; and if the PPF levy has been paid directly by the DNO (and reported in HR & Non-op training) these have added to actual pension costs.

2. The difference is then treated as it would have been for DPCR4 funding i.e. 57.7 per cent is treated as an addition to RAV and the remainder as opex.

3. The RAV element is then used to calculate the missing return on RAV and depreciation.

4. The missing RAV return and depreciation are then used together with the opex element, with an offset for changed tax allowances (at 30 per cent as modelled) that would have been gained to show the 'cash' position that would have occurred.

5. A return (currently at the cost of capital) is then allowed each year on the value of the 'cash' to bring the total to the March 2010 position. This is then added into the financial model to be additional revenue in DPCR5.

6. The remaining RAV will be funded through the rolled forward RAV in the normal way.

1.122. See example below:

Example of pension true up calculation: £3.9m (in 2007/08 prices) to be added to financial model; £4.5m residual in RAV

	2002/03 prices								**Notes**
DPCR4 allowance			**2006**	**2007**	**2008**	**2009**	**2010**	**Total**	
	Capex		28.9	27.7	27.7	28.3	28.9	141.4	
	Opex		21.2	20.3	20.3	20.7	21.2	103.6	
			50.0	48.0	48.0	49.0	50.0	245.0	Allowance per FP
Actual pension spend				Nominal prices			2007/08 prices		
	Normal		15.0	15.0	15.5	16.0	16.0	77.5	
	PPF Levy		2.0	2.0	2.0	3.0	3.0	12.0	
	Deficit		45.0	37.0	35.0	36.0	36.0	189.0	
			62.0	54.0	52.5	55.0	55.0	278.5	Total spend
	2002/03 prices								
Actual pension spend									
	Normal		15.6	15.1	14.9	16.2	16.2	77.9	Deflate to 2002/03
	Deficit		43.2	34.6	31.5	33.2	33.2	175.6	
			58.8	49.6	46.4	49.4	49.4	253.6	
Capex /opex split DPCR4 basis									
	Capex		33.9	28.6	26.8	28.5	28.5	146.3	Split per DPCR4 assumption
	Opex		24.9	21.0	19.6	20.9	20.9	107.3	
			58.8	49.6	46.4	49.4	49.4	253.6	
	2002/03 prices								
Difference									
	Capex		5.1	0.9	(0.9)	0.2	(0.4)	4.9	Difference to be addressed
	Opex		3.7	0.7	(0.7)	0.2	(0.3)	3.6	
			8.8	1.6	(1.6)	0.4	(0.6)	8.6	
RAV impact									
	Opening		0.0	5.1	5.8	4.5	4.5		
	Additions		5.1	0.9	(0.9)	0.2	(0.4)		Capex from above
	Depreciation		0.0	(0.3)	(0.3)	(0.3)	(0.3)		Over 20 years
	Closing		5.1	5.8	4.5	4.5	3.9		
Depreciation period		20							
Additional tax saving			2.6	0.5	(0.5)	0.1	(0.2)		100% allowances
Tax rate			30%	30%	30%	30%	30%		As modelled
		2002/03 prices							
To address								Total	
RAV return		5.545%	0.1	0.3	0.3	0.3	0.2	1.2	Return on RAV not funded
Opex			3.7	0.7	(0.7)	0.2	(0.3)	3.6	Opex not funded
Depreciation			0.0	0.3	0.3	0.3	0.3	1.1	
Tax benefit			(2.6)	(0.5)	0.5	(0.1)	0.2	(2.6)	
								3.3	
Remaining RAV							3.9	3.9	
		2007/08 prices						Total	
RAV return			0.2	0.4	0.3	0.3	0.3	1.4	
Opex			4.4	0.8	(0.8)	0.2	(0.3)	4.3	
Depreciation			0.0	0.3	0.4	0.3	0.3	1.3	
Tax benefit			(3.1)	(0.6)	0.6	(0.1)	0.2	(3.0)	
Cash funding			1.4	0.9	0.5	0.6	0.5	3.9	
Time value of cash			1.4	0.9	0.5	0.6	0.5	3.9	
Years remaining			4.5	3.5	2.5	1.5	0.5		Years to 2010
Remaining in RAV							4.5	4.5	Already added to RAV