Electricity Distribution Price Control Review (DPCR5)

September and October Updates to Initial Proposals

Electricity North West Response

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Executive Summary

This response addresses the revisions to the Initial Proposals contained in the October letter and the September Update. In this response, the core cost allowances of the October update are addressed first, before moving on to the detailed cost and risk issues raised by the September update.

At this important time in the price control review process, it is essential to reflect on the progress made since the Initial Proposals. In our 14 September response we demonstrated that the package was inappropriate given the future demands on the network and the regulated business. The content of the September update and 5 October letter reinforce our position that Ofgem's proposals represent an inappropriate level of risk for the network and for the customers of the North West.

We are disappointed that Ofgem has failed to address our concerns. We remain deeply worried that we will not be allowed sufficient revenue to cover our required capital investment and indirect costs. Without this it will be impossible to deliver the challenging investment programme needed to rebuild the network and begin the transformation to a low carbon economy. Furthermore, in the current environment we have proposed modifications to the regulatory framework to prevent the significant increase in risk we are facing resulting in big increases in cost for customers. We are disappointed that Ofgem's current approach introduces additional risks rather than helping to mitigate risk increases.

Inadequate allowance for Indirect Costs

Ofgem's approach to assessing required expenditure using comparative efficiency results in insufficient indirect allowances being proposed for ENW.

We believe that these insufficient allowances result for a number of reasons, including:

- Use of a flawed modelling approach – we have previously suggested ways that would correct these flaws, improve robustness and validity of the modelling, improve results of statistical tests and increase ENW's baseline by £19m
- Unjustified selection of overall benchmarks for network operating costs and indirects, leading to a result that favours other DNOs – reducing ENW's baseline by £11m
- Errors in Ofgem's analysis producing erroneous modelling results
- Flaws in approach to setting baselines for non-modelled costs

- An inappropriate assumption that all companies can catch up to modelled efficient costs by 2008/09 (ie at a point of time already in the past) – whereas in reality in takes time to implement savings
- Failure to provide allowances for new obligations

We have been advised by our econometric expert advisers that failure to address these points will render the Ofgem analysis unable to withstand external scrutiny. The Ofgem analysis does not recognise the significant efficiencies already included in ENW's FBPQ; our confidence in the validity and efficiency of our forecasts remains high and the Ofgem analysis does not present any compelling evidence to challenge this position. Therefore, we insist that our indirect cost allowance be increased by £52million to return it to FBPQ levels.

Inadequate funding for investment unit costs

We maintain that it is inappropriate to judge unit costs on an asset-type basis, particularly when the framework does not align with how any DNO actually carries out planned capital investment work.

We are happy to accept the application of Ofgem's benchmark unit costs in the round and have acknowledged to both Ofgem and GEMA that such analysis suggests that our costs are a modest 2% above the aggregate median position. However, Ofgem's use of a cherry-picking approach implies that our unit costs are around 7% more expensive than Ofgem's benchmarks. Due to the detailed market testing behind our procurement practices and open-book approach with our Service Provider, we do not believe this benchmark represents an achievable position replicable in practice. To apply a lesser-of rule without applying appropriate normalisation does not represent equitable practice and we suggest that the lack of a standardised costing framework would be exposed under detailed external scrutiny.

We are pleased to note that Ofgem recognise that more work is required to complete the analysis of connections costs. There is clearly an inconsistent data set if companies are reporting wildly different numbers of units that are orders of magnitude apart in Ofgem's current cost analysis. We have suggested to Ofgem how appropriate changes could be made and urge them to amend their approach.

Increased risk in the regulatory framework

We have commented on 14 September on changes required to Ofgem's proposals in relation to the losses, quality of supply, transmission exit charge and customer satisfaction incentives to ensure that these mechanisms do not increase DNOs risk in DPCR5. We also note the propensity of the outputs regime, additional Guaranteed Standards and additional obligations to increase DNO risk. We have proposed a practical series of changes to the regulatory framework in our most recent meeting with the Sub-Committee of the Authority to redress this trend.

Our concerns grow as a result of some of the proposals included within the September update; Ofgem's proposals to disallow significant amounts of reinforcement expenditure required to connect new customers to our network and the introduction of inappropriate proposals for dealing with within-period cost shocks will introduce more risk.

We have encouraged Ofgem to use specific elements of the regulatory toolkit to manage risk in DPCR5 to appropriate levels. Whilst we support the methodologies proposed by Ofgem to manage uncertainty in the September Update, we believe that the proposed application rules are inappropriate to counteract the level of risk in the price control and may actually introduce more risk to the detriment of customers. Ofgem must ensure that the rules surrounding the risk mitigation mechanisms do not restrict their application to ensure there is no consequential increase to risk and, therefore, the cost of capital.

October Update Response

1 Operational Cost Analysis (Response to Appendix 1)

1.1 Overview

Ofgem's approach to assessing required expenditure results in insufficient indirect allowances being proposed for ENW.

We believe that these insufficient allowances result for a number of reasons, including:

- Use of a flawed modelling approach – we have previously suggested ways that would correct these flaws, improve robustness and validity of the modelling, improve results of statistical tests and increase ENW's baseline by £19m
- Unjustified selection of overall benchmarks for network operating costs and indirects, leading to a result that favours other DNOs – reducing ENW's baseline by £11m
- Errors in Ofgem's analysis producing erroneous modelling results
- Flaws in approach to setting baselines for non-modelled costs
- An inappropriate assumption that all companies can catch up to modelled efficient costs by 2008/09 (ie at a point of time already in the past) – whereas in reality in takes time to implement savings
- Failure to provide allowances for new obligations

We have been advised by our econometric expert advisers that failure to address these points will render the Ofgem analysis unable to withstand external scrutiny. The Ofgem analysis does not recognise the significant efficiencies already included in ENW's FBPQ; our confidence in the validity and efficiency of our forecasts remains high and the Ofgem analysis does not present any compelling evidence to challenge this position. Therefore, we insist that our indirect cost allowance be increased by £52million to return it to FBPQ levels.

We will continue to incentivise our service provider to efficiently manage costs, mirroring the incentive mechanisms in the regulatory framework; however the level of cost reductions you are suggesting does not reflect an appropriate recognition of the significant efficiencies already included in ENW's FBPQ.

1.2 Ofgem's Modelling Changes

We note that Ofgem have made a number of changes and corrections to their analysis presented in the Initial Proposals. We agree with the majority of Ofgem's changes, but are disappointed that Ofgem have not made further changes to reflect the suggestions we made in our response to the Initial Proposals. In particular:

- We are pleased that Ofgem have recognised the distorting effect that insourcing and outsourcing decisions can have on model results, but are concerned that a number of material errors are apparent in their new adjustments that have potentially introduced more random volatility and noise into models.

- We welcome the fact that Ofgem have now based their baselines for IT costs on consultant analysis; consultants are much better placed to understand the complex drivers of these costs than econometric models.

- We agree that it is sensible to include TMA admin costs within models given uncertainty as to whether definitions have been interpreted consistently by DNOs.

1.3 Significant Remaining Issues

We made a significant number of recommendations to improve Ofgem's model in our response to the Initial Proposals. We are very disappointed that Ofgem have not, in the majority of cases, acted on our proposals. In order to correct the most fundamental flaws and inequities in Ofgem's modelling approach, Ofgem should make the following changes to their modelling approach to address the key issues. These are the minimum changes that must be made before the modelling approach can be considered to be appropriate. There will inevitably be further outstanding modelling issues that we would be happy to work with Ofgem to address in order to further improve modelling quality (for example, at the moment we have tried to remain as close to Ofgem's approach as possible, but consider that other approaches, such as DEA and SFA, also warrant further investigation).

Issue	**Recommendation**
Inappropriate costs included / excluded within models	Remove property costs from models to recognise unique drivers of this area of expenditure. Allowances for these activities should be based on consultant review Include non QoS faults within models to reduce current boundary issue
Inappropriate cost normalisation used within models	Remove cable replacement costs from models to avoid double counting Make regional cost adjustments for EDF LPN only and limit adjustment to activities that must be undertaken within DNO's operating area
Inappropriate cost drivers	Adjust measure of direct costs used to model indirect costs to include Ofgem's modelled efficient costs for network operating costs rather than actual costs – removing the perverse advantage to DNOs whose network operating costs are inefficient Remove false weighting of drivers by including

Issue	Recommendation
	Ofgem's identified drivers within multivariate models Cease to use "Single Group" model – recognising that "Groups" models more correctly reflect drivers of expenditure"

Issue	Recommendation
Inappropriate choice of benchmark given modelling shortcomings eg obvious boundary issues and poor statistical test results	Combine results of NOC and indirect cost models to create a single benchmark – reducing the impact of cherry-picking across NOC and indirect costs Use independent top down models to test validity of core model results Consider qualitative assessment of activities undertaken by DNOs in determining an appropriate benchmark
Shortcomings in rolling forward baseline costs to DPCR5	Adjust catch up and frontier shift assumptions to recognise that it will take time for DNOs to reduce their costs to proposed levels, and that it is impossible for DNOs to catch up to baseline costs by 2008/09 by assuming DNOs catch up to baseline over the five years of the price control period and applying frontier shift assumptions from 2010/11 Provide allowances for new areas of obligation eg output reporting, condition data capture, new guaranteed standards, requirement to undertake customer surveys
Insufficient allowances for non-modelled costs	Consider relative efficiency in setting allowances to ensure incentive on DNOs to manage efficiency eg low volume high value faults

In order to illustrate the volatility of Ofgem's modelling and its sensitivity to changes, we present below for illustration the effects of making six of our proposed changes on indicative allowances for DPCR5. These are

- Reverse cable replacement costs to avoid double counting with network investment approach
- Remove property costs from modelling – reflecting the unique drivers of this activity

- Make regional cost adjustments for EDF LPN only and limit adjustment to activities that must be undertaken within DNO's operating area

- Cease to use "Single group" within modelling recognising that it does not correctly reflect drivers of expenditure

- Remove false weighting of drivers by including Ofgem's identified drivers as independent variables within multivariate analysis

- Adjust measure of direct costs used to model indirect costs to recognise Ofgem's modelled efficiency of network operating costs – removing advantage to DNOs whose network operating costs are inefficient

These proposed changes improve the robustness of modelling by:

- Removing distorting affect of costs with unique cost drivers

- Removing double count between operating cost and investment cost assessment

- Removing arbitrary capping of composite cost drivers

- Placing greater weighting on models that include more appropriate drivers of indirect costs

- Removing current disadvantage to DNOs with efficient network operating costs

- Adjusting for the demonstrable cherry-picking associated with separate NOC and indirect cost baselines

- Improving results of statistical tests

We have deliberately presented this analysis excluding any singleton adjustment. However, we continue to maintain that Ofgem's current approach incorrectly models the fixed costs that can be shared by DNOs in the same ownership group and that a singleton adjustment is appropriate.

Comparison of Ofgem's efficiency scores in IP with those after revisions proposed by ENW

	Ofgem's October letter (core models)				Revised results			
	NOCs		Indirects (average of single group and groups)		NOCs		Indirects (groups)	
	Efficiency	Rank	Efficiency	Rank	Efficiency	Rank	Efficiency	Rank
CN West	110%	9	115%	13	107%	11	110%	10
CN East	99%	8	91%	3	106%	10	85%	3
ENW	83%	2	107%	12	85%	4	99%	7
CE NEDL	95%	7	94%	5	94%	8	100%	8
CE YEDL	116%	11	84%	1	93%	7	83%	2
WPD S Wales	85%	4	103%	9	92%	6	111%	11
WPD S West	95%	6	93%	4	91%	5	90%	4
EDFE LPN	89%	5	103%	10	151%	13	139%	14
EDFE SPN	110%	10	100%	8	161%	14	115%	12
EDFE EPN	121%	13	125%	14	127%	12	128%	13
SP Distribution	123%	14	94%	6	72%	2	94%	5
SP Manweb	120%	12	96%	7	94%	9	97%	6
SSE Hydro	64%	1	105%	11	64%	1	109%	9
SSE Southern	84%	3	84%	2	84%	3	72%	1

Additionally, we have combined the results of the models for network operating costs with those of indirect costs, and calculated a combined efficiency score in order to reduce the effect of cherry-picking across the two areas of activities. This analysis delivers the efficiency scores in the following table.

Comparison of Ofgem's combined NOC and indirect efficiency scores with combined efficiency score after revisions proposed by ENW

	Ofgem's October letter (average of single group and groups)	Ofgem's October (groups)	Revised efficiency scores – adjusted for 6 changes described above (groups)
CN West	113%	113%	109%
CN East	94%	93%	93%
ENW	97%	93%	94%
CE NEDL	94%	96%	98%
CE YEDL	96%	95%	87%
WPD S Wales	95%	98%	103%
WPD S West	94%	95%	90%
EDFE LPN	99%	102%	142%
EDFE SPN	104%	106%	132%
EDFE EPN	124%	121%	128%
SP Distribution	103%	102%	87%
SP Manweb	104%	105%	96%
SSE Hydro	88%	92%	89%
SSE Southern	84%	82%	77%

We calculate that the use of this combined baseline, together with the six changes to Ofgem modelling approach described above, would provide ENW with an extra £19m allowances for the DPCR5 period. Our proposed changes also make material changes to the baselines applied to several other DNOs, demonstrating that several other DNOs are inappropriately advantaged or disadvantaged by the flaws in Ofgem's current approach; making these changes would improve the methodology to the benefit of customers in all areas of the UK.

This clearly shows the very large change to results that can arise due to a small number of logical changes to assumptions – illustrating the sensitivity of Ofgem's models to their modelling assumptions.

Statistical test results show that these proposed changes have slightly improved the models, but Ofgem needs to keep looking for further improvements.

Clearly, such material changes to modelled efficiency call into question the robustness of Ofgem's modelling. This magnitude of potential change in modelled costs shows that Ofgem's modelling approach has been inappropriate, with an unwarranted adverse effect on ENW. It is concerning that such cuts were not challenged by Ofgem's own tests of the appropriateness and credibility of the proposals.

It is important to recognise that, even with these changes, the results would still not recognise the quality of customer service provided or increased cost pressures due to new obligations. The range of results from our model, combined with the fact that the models still remain poor especially in some areas, still suggest that differences between DNO costs and modelled costs cannot be confidently assumed to be attributable to relative efficiency alone. We have identified a number of errors in Ofgem's analysis. A number of these, particularly an erroneous approach to normalising for contractor indirects, will have had a material impact on overall results.

Errors in the model, combined with erroneous modelling assumptions, lead to inappropriate modelling results and force us to conclude that Ofgem's modelling approach is far from "firm but fair". Our experienced and respected econometric consultants, Oxera, advise that the analysis would currently be unable to stand up to independent scrutiny.

Ofgem must employ caution in using model results to set allowances by adjusting for errors and noise in the modelling, providing the potential for outperformance (ie, a "carrot") and allowing enough time for any proposed improvements to be made. This will avoid the prospect of insufficient allowances for ENW resulting in inappropriate short-term cost cuts which will increase both short-term and long term risks and increase long-term costs to customers.

1.4 Ofgem's Choice of Benchmark

We are pleased that Ofgem have recognised that the use of different benchmarks for different DNOs risks disadvantaging some DNOs relative to others. We believe, however, that Ofgem's decision to move all DNOs to upper quartile (indirects) and

upper third (network operating costs) is inappropriate as it fails to recognise evidence that suggests such benchmarks are unduly stringent.

In establishing the benchmark to be used for allowance setting Ofgem must take into account:

- Shortcomings in the data used for modelling
- Boundary issues between models as a result of operating structures and DNO decisions as well as reporting irregularities
- The cherry-picking effect of choosing separate benchmarks for each cost grouping, including setting separate allowances for capex and opex activities
- The exacerbation of this cherry-picking effect as a result of insourcing and outsourcing strategies influencing the modelled efficiency in each cost block.
- The fact that different DNOs form the upper quartile in NOCs and indirects meaning that setting baselines for companies based on upper quartile in both models is inappropriate
- The level of customer service provided by each DNO and the impact this has on value for customers
- The quality of the outputs that a DNO has committed to for DPCR5
- The level of efficiency for the DNO as suggested by a range of top down models
- The extent to which apparent "inefficiencies" may be a result of the limitations of modelling approach

A wide range of evidence proves that Ofgem's choice of benchmark is inappropriately harsh on DNOs and will lead to excessive cost cutting that is damaging to customers' long term interests.

1.4.1 Very wide range of results

Ofgem's models continue to show a very wide range of efficiency scores for DNOs. It is incredible to believe that this range of results is solely attributable to differences in efficiency after five price control periods of regulatory target setting. Ofgem themselves acknowledged in their Initial Proposals that "inconsistencies in the cost reporting and FBPQ data….undermine the robustness of [their] analysis"; such inconsistencies will be contributing to the observed wide range of results.

1.4.2 Poor statistical test results

Statistical tests results are not sufficiently robust to provide confidence that benchmarks can be set at upper quartile. Setting targets at upper quartile or upper third based on models with R^2 values of as low as 0.5 is inappropriate; such low statistical test results suggest that the deviations from modelled costs may result from more than just inefficiencies and may instead result from, for example, missing cost drivers or inappropriate functional form.

1.4.3 Alternative models suggest very different results

Replication of modelling undertaken at DPCR4 gives very different results from Ofgem's analysis.

	2008/09 NCCF		Ofgem IP (average of NOC and indirects models)		Ofgem IP (average of NOC and indirects after Ofgem judgement		Ofgem IP (top down)	
	Efficiency	Rank	Efficiency	Rank	Efficiency	Rank	Efficiency	Rank
CN West	101%	9	112%	13	113%	12	113%	13
CN East	87%	3	95%	6	95%	7	98%	8
ENW	94%	4	95%	7	94%	6	102%	9
CE NEDL	97%	7	94%	5	90%	5	95%	5
CE YEDL	95%	5	100%	9	101%	9	95%	6
WPD S Wales	95%	6	94%	4	79%	2	110%	12
WPD S West	99%	8	94%	3	85%	3	109%	11
EDFE LPN	128%	14	96%	8	114%	13	83%	1
EDFE SPN	124%	13	105%	10	109%	11	108%	10
EDFE EPN	114%	12	123%	14	137%	14	114%	14
SP Distribution	77%	1	108%	12	104%	10	89%	3
SP Manweb	105%	11	108%	11	101%	8	94%	4
SSE Hydro	102%	10	85%	2	79%	1	86%	2
SSE Southern	86%	2	84%	1	86%	4	97%	7

It is hugely disappointing that, given the time and resource expended on developing the RRP to support NCCF modelling, that these approaches have been largely ignored, even as a sense check, in favour of a clearly less robust set of models. Going forward it will be important to develop cost reporting to provide the right data for comparative efficiency, rather than develop comparative efficiency approaches that work with the data available. For DPCR5, NCCF must form a key component of modelling approach given that it is the only cost reporting basis that has been consistently audited throughout DPCR4 via the annual RRP process.

1.4.4 Biased use of "regulatory judgement"

We are disturbed at the extent of regulatory judgement in the determination of efficiency scores by DNO. We are particularly concerned that there is limited transparency in the determination of these benchmarks.

The table below compares the efficiency scores used by Ofgem to those calculated from the average of their core models: Single Group and Groups. We note that the efficiency scores allocated to WPD are materially improved relative to those suggested by Ofgem's models. Similarly, EDF's are materially worse than suggested by models.

	% efficiency as used by Ofgem		Average of Ofgem's Single Group and Groups core models			
	Efficiency Scores		Efficiency Scores		Variance to scores used by Ofgem	
	NOC	Indirects	NOC	Indirects	NOC	Indirects
CN West	110%	115%	110%	115%	-1%	0%
CN East	101%	90%	99%	91%	-2%	1%
ENW	83%	105%	83%	107%	0%	2%
CE NEDL	91%	90%	95%	94%	4%	3%
CE YEDL	116%	87%	116%	84%	0%	-3%
WPD S Wales	74%	85%	85%	103%	12%	18%
WPD S West	86%	84%	95%	93%	8%	9%
EDFE LPN	105%	122%	89%	103%	-16%	-19%
EDFE SPN	115%	102%	110%	100%	-5%	-2%
EDFE EPN	134%	140%	121%	125%	-12%	-15%
SP Distribution	115%	92%	123%	94%	8%	2%
SP Manweb	108%	93%	120%	96%	11%	3%
SSE Hydro	61%	97%	64%	105%	3%	8%
SSE Southern	87%	84%	84%	84%	-4%	0%
QUARTILE	87%	87%	86%	93%	-1%	6%
Upper third	88%	90%	91%	94%	2%	4%

Ofgem's selection of efficiency scores materially moves upper quartile and upper third targets that all DNOs' baselines are set against – this effect is particularly material for indirects, where the upper quartile target is tightened by 6%. The selection of benchmarks also narrows the difference between upper quartile and upper third for network operating costs to 1% - effectively providing only minimal acknowledgement of the very wide range of modelling results. This disadvantages the vast majority of DNOs.

Ofgem have not shared any information to substantiate reasons for deviating so far from the core models. The Ofgem team acknowledge that they consider all of the variations to models in determining relative efficiencies. The table below demonstrates that the scores used by Ofgem are also materially different to the average of all of the 55 models that Ofgem have shared with DNOs. Given Ofgem's previous claims to have developed sophisticated and robust models it seems strange to us that Ofgem have largely ignored their core results in setting baselines. We recognise that Ofgem will always need to exercise regulatory judgement in interpreting model results but contest that such material deviations from model results are extreme and are not substantiated by any evidence that Ofgem have shared. Ofgem's approach suggests an erroneous pre-conceived view of DNO efficiency.

% efficiency as used by Ofgem

	Efficiency Scores	
	NOC	Indirects
CN West	110%	115%
CN East	101%	90%
ENW	83%	105%
CE NEDL	91%	90%
CE YEDL	116%	87%
WPD S Wales	74%	85%
WPD S West	86%	84%
EDFE LPN	105%	122%
EDFE SPN	115%	102%
EDFE EPN	134%	140%
SP Distribution	115%	92%
SP Manweb	108%	93%
SSE Hydro	61%	97%
SSE Southern	87%	84%
QUARTILE	87%	87%
Upper third	88%	90%

Average of all models shared by Ofgem

	Efficiency Scores			Variance to scores used by Ofgem	
	Top Down	NOC	Indirects	NOC	Indirects
CN West	113%	110%	112%	0%	-3%
CN East	96%	102%	88%	1%	-2%
ENW	99%	85%	104%	1%	-1%
CE NEDL	94%	94%	96%	3%	5%
CE YEDL	95%	113%	82%	-3%	-4%
WPD S Wales	96%	84%	105%	10%	19%
WPD S West	97%	93%	93%	6%	9%
EDFE LPN	98%	91%	113%	-14%	-9%
EDFE SPN	109%	114%	106%	-1%	4%
EDFE EPN	129%	121%	123%	-12%	-17%
SP Distribution	98%	116%	93%	2%	1%
SP Manweb	100%	115%	101%	6%	8%
SSE Hydro	85%	68%	111%	7%	13%
SSE Southern	90%	85%	79%	-3%	-5%
	95%	86%	93%		
	96%	92%	94%		

We calculate that this subjective choice of benchmarks is penalising ENW by £11m.

We are particularly surprised that Ofgem's regulatory judgement has disadvantaged ENW given their acknowledgement of the following features of ENW:

- An innovative business model that drives down the direct cost of activities – resulting in ENW's costs forming upper quartile for network operating costs against which other DNOs' costs are challenged – securing cost reductions across the industry
- Upper quartile quality of supply performance
- Pioneering research and development activities that focus on innovative development of distribution networks
- Leadership in promoting competition in connections – allowing customer choice and facilitating competition
- Leadership in the development of CBRM and outputs – allowing asset interventions to be prioritised to optimise investment plans and maximise asset lives as part of a visible commitment to deliver the right investments for customers
- Focus on securing reductions to areas of costs such as wayleaves and NGET exit charges reducing overall bills to customers during DPCR4 and DPCR5
- Identifying excluded service revenue opportunities that reduce overall bills for customers

1.5 Competition Commission's Best Practice

Ofgem's approach falls some way short of meeting the recommended Competition Commission best practice included within their document "Suggested best practice for submissions of technical economic analysis from parties to the Competition Commission". This document outlines the Competition Commission's three general principles which should apply to economic modelling:

1.5.1 Clarity and transparency

"*Submissions should not only present clearly the results and conclusions of the economic analysis undertaken, but they should also clearly state the methodology used, the assumptions made in reaching results, the justification for the methodology and the assumptions, and the robustness of the results to any assumptions made. Submissions should be understandable to non-economists, and CC economists should be able to determine how the analysis enables the parties' economic experts to reach the submitted conclusions.*"

The fact that Ofgem have not provided us with detailed methodology or evidence sufficient to allow us to understand the regulatory judgement that Ofgem have applied to model results is clearly contrary to this principle.

1.5.2 Completeness

"*Submissions should contain a complete description of the analysis undertaken. All relevant assumptions should be discussed and choice of techniques explained. Relevant econometric output, diagnostic tests and checks for robustness should be included. Where references to academic literature have been made, these should also be cited.*

The CC should be able to understand fully both the results and the economic theory and modelling that are generating those results, without having to seek more information from the submitting party."

The files shared by Ofgem with DNOs do not provide details of all data sources and calculations used to set DNO benchmarks, indeed Ofgem have refused to provide us with some files. This falls someway short of the Competition Commission's requirement for "'Raw' data should be provided wherever possible…. because the aggregation and cleaning of data may have a significant impact on the outcome of statistical or econometric analysis".

1.5.3 Replication of results

"*In a number of cases, the CC will want to replicate the results of the analysis that has been submitted. This means that parties should be prepared to respond to a CC request, at very short notice, for all relevant computer code and data files necessary for the CC's economists to reproduce the results presented in the parties' submission. This will include the raw and the cleaned data and the programs for obtaining the latter from the former.*"

Our experience has been that it takes a great deal of time, specialist knowledge and tools and an element of "trial and error" for DNOs to build models that can

reasonably replicate Ofgem's core models. In several cases our results deviate from Ofgem's by several percentage points. We have been unable to replicate Ofgem's overall choice of benchmarks because of a lack of transparency of approach.

1.6 Generating allowances from Benchmarks

Ofgem provides no time for management to make the target improvements. This implies that Ofgem considers that it is absolutely certain of the accuracy of its upper quartile benchmark of indirect costs (and beyond, as there must be some 'carrot' to provide an incentive for companies to outperform) and that it is achievable immediately. This is not practicable. Ofgem should adjust catch up and frontier shift assumptions to recognise that it will take time for DNOs to reduce their costs to proposed levels and that is impossible for DNOs to catch up to baseline costs by 2008/09. It is far more appropriate to assume that DNOs catch up to baseline over the five years of the price control period and apply frontier shift assumptions from 2010/11

Ofgem provides no allowances for new areas of obligation. When faced with new obligations without appropriate funding, DNOs will be forced to further curtail activities such as asset replacement in order to discharge their new responsibilities. DNOs have provided details of the anticipated costs of these new activities; allowances should be made for these activities.

1.7 Non-modelled Cost Changes

In setting allowances for excluded costs, it is of fundamental importance to recognise the potential boundaries between modelled costs and costs excluded from modelling and the implications for distortions in resulting allowances.

1.7.1 Scope of non-modelled costs

- We are pleased that Ofgem have recognised that IT costs are best assessed by specialist consultants rather than via modelling.

- We are disappointed that Ofgem continue to model non-operational property capex via models rather than by consultant review. Econometric models ignore key drivers of investment such as legislative changes requiring air conditioning unit changes, etc.

1.7.2 Approach to setting baselines for non-modelled costs

We note that Ofgem have made some progress in addressing our concerns about their approach to setting allowances for non-modelled costs. However, a number of issues persist in Ofgem's approach to setting baselines for non-modelled costs that must be addressed.

- Failure to recognise boundaries with modelled costs

- Ofgem recognise that significant boundaries exist between reported non QoS fault costs and reported QoS fault costs. Setting QoS fault costs based on results of a model and non QoS faults based on the average of historical costs advantages DNOs who report high levels of non QoS faults. Ofgem's own analysis had previously suggested that ENW's non QoS faults were at 32% of benchmark. Clearly, setting allowances based on average historical costs materially disadvantages ENW in this area. These costs should be included within core models.

- Errors in applying consultant recommendations
  - Ofgem's baselines are less than the efficient costs suggested by their consultants

- Failure to test for and reward relative efficiency
  - Ofgem's modelling clearly demonstrates that ENW's network operating costs are within the efficiency upper quartile. Setting allowances for Low Volume High Cost faults and non-QoS faults based on lowest of average and forecast costs, without taking into account the relative efficiency of network operating costs and projected future efficiency improvements, disadvantages DNOs such as ENW who can demonstrate efficient network operating costs. Such an approach means that ENW is currently being penalised twice: once by getting no benefit for our historical costs being efficient and again for having forecast further efficiencies. Ofgem must provide an incentive on DNOs to deliver efficient costs.

- Failure to take into account unusual events in calculating average costs to roll forward, for example
  - In 2006/7 ENW incurred two unusual cable damages which resulting in atypically high cable damage recoveries for that year. It should not be assumed that such unusual levels of recoveries are sustainable.

2 Network Investment (Response to Appendix 2)

2.1 Overview

We are pleased to note that Ofgem have moved significantly from the positions adopted in the Initial Proposals document and have accepted many of the arguments we have made. However there are still areas where we either disagree with, or there has been insufficient transparency of process to understand, Ofgem's methodology. We consider that these issues require further debate before the overall price control discussion can be moved on from a detailed dissection of proposed allowances to a more strategic level.

2.2 Scope Issues

For ENW, we note that the majority of the scope issues raised in the IP have been satisfactorily resolved. We also appreciate the accommodation that has been reached on the treatment of marginal vertical clearances following discussions with the HSE, and accept that an 80% volume assumption is not inappropriate given the amount of re-survey work required. By the time of the 2012 re-opener process, we plan to have completed the re-surveys required and propose to raise the issue with Ofgem at that time if the proportion of site replacements is significantly higher than that implied in the current proposals.

With regard to the minor scope reductions for asset replacement and reinforcement, in both cases Ofgem have not made the specific conclusions behind this analysis available. We are therefore currently applying our risk assessment processes to the assessment in order to identify which projects would not be undertaken as a consequence and hence need to be factored out of the associated forthcoming outputs proposal.

For Diversions, Ofgem's general wording implies that the majority of movement is due to an updated view of Injurious Affection effects, however the change in proposed allowances for ENW appears aligned to the inclusion of the Parkside redevelopment scheme only. We appreciate that this is a complex area but Ofgem's proposals still fall £6M short of our projected forecasts. In our view, the movement from the IP will fund either Parkside, or the anticipated increase in terminations due to Injurious Affection claims, but not both.

2.3 Unit Cost Issues

2.3.1 Asset replacement unit costs

We note that Ofgem have neither moved significantly on this issue, nor published an updated set of unit costs to accompany the proposed new allowances. We maintain that it is inappropriate to judge unit costs on an asset-type basis, particularly when the framework has been carried over from RRP asset reporting and does not necessarily align with how any DNO actually carries out planned capital investment work.

We are happy to accept the application of Ofgem's benchmark unit costs in the round and have acknowledged to both Ofgem and GEMA that such analysis suggests that our costs are a modest 2% above the aggregate median position. This approach is consistent with that adopted for the Operational cost analysis in its acknowledgement of potential 'frontier' and 'upper quartile' positions. Currently, all companies receive unit cost reductions due to the cherry-picked application of the benchmarks.

Use of the cherry-picking approach implies that our unit costs are around 7% more expensive than Ofgem's benchmarks. Due to the detailed market testing behind our procurement practices and open-book approach with our Service Provider, we do not believe the benchmark represents an achievable position replicable in practice. All companies will have areas of apparent efficiency or inefficiency in their cost bases due to economies of scale, accounting allocations, material specifications, operational practice etc. To apply a lesser-of rule without applying appropriate normalisation does not represent equitable practice and we suggest that the lack of a standardised costing framework would be exposed under detailed external scrutiny.

2.3.2 Clearances

We have corresponded with Ofgem on the unit costs of clearances and answered a detailed information request. We acknowledge that this area is complex but note that Ofgem appear to have made virtually no adjustments to the Initial Proposals cuts in the light of this and have not given any feedback following the questioning.

As such, we remain baffled as to the basis for the significant reductions due to clearance unit costs (amounting to £13M by our calculations) and are frustrated that the undertaking by Ofgem to publish the unit costs used for comparison, made at our bilateral meeting on 16 September, has never been honoured. We therefore do not accept the proposed reductions and contend that the assessment process for these costs is both deeply flawed and non-transparent.

2.3.3 Poles and other areas

We note that Ofgem have accepted arguments regarding the premium required above LV costs to conduct work on both the HV and EHV overhead line networks. As discussed at our bilateral meetings with Ofgem and with GEMA, we accept that the residual unit cost challenge on pole replacements is ours to meet, and also that the unit cost issue for reinforcement is due to our pricing in of anticipated price rises for primary transformers that have not, in the event, come to pass.

2.3.4 Operational IT

Although the proposed reduction is modest, we have never, despite repeated requests, had either a copy of the PB Power report or the basis for the proposed reduction to our forecast explained to us such that we can respond appropriately. As such we remain frustrated that we have been unable to achieve dialogue on this subject, let alone agreement on final allowances.

3 Pulling Costs Together (Response to Appendix 3)

We are pleased that a number of omissions from the Initial Proposals IQI matrix have been corrected (ie flooding, BT21stCN costs and traffic management administration costs). We suggest that substation electricity should not be included within the IQI calculation. Several DNOs, including ENW, had only a very short time to develop forecasts without any track record of incurring expenditure; it would be wrong to penalise them for inaccurate forecasts in these circumstances.

We support the continued use of the Initial Proposals IQI matrix for DPCR5. We would be concerned if Ofgem modified its IQI incentive package for the Final Proposals without recognising the impact upon the risk/reward balance.

We reiterate our concerns with Ofgem's proposal to modify the start to earn points in the matrix. We believe that the incentive properties of the mechanism have diminished throughout the price control process due to delays in publication and by the proposal to modify the strength of the incentive after the "bidding" process has completed. We suggest that the start to earn points should not be made tougher as the IQI mechanism (supported by agreed outputs) is one of the most tightly controlled aspects of the price control and the additional tightening would appear to be unnecessary.

4 Financial Issues (Response to Appendix 4)

4.1 Overview

We appreciate that the October update to the Initial Proposals focuses on the correction of errors, omissions and unintended consequences; however, ENW are very concerned that at this late stage of the price control review we are still in the position of using a "working assumption" for WACC.

Specific comments are made below to the points raised in Appendix 4 – Financial Issues where appropriate.

4.2 Pensions

Relevant comments are contained in the response to Annex 1 – Pensions Methodology, which follows at Section 4.9. We have not included any comment here on the Price Control Pension Principles Third Consultation document, sent out on 16 October.

4.3 RAV Additions

We do not agree that an adjustment should be made to the actual spend on ESQCR in the RAV roll forward. We believe these costs should be treated in the same way as any other cost allowance with the actual costs incurred added to the RAV and any efficiency/inefficiency reward or penalty picked up through the capex roller incentive. Ofgem's current approach does not fund a significant proportion of legitimate costs incurred to meet the ESQCR legal obligations.

Similarly all pension PPF and admin costs should be allowed in the pension true-up mechanism. The cash costs in 2009/10 include two years of PPF levy due to timing of invoicing. The basis of calculation for the PPF levy was sent to you in our response to your question FI 2059.

4.4 Excluded Services

Clarification of the comment relating to the treatment of top-up and standby and enhanced system security as non-relevant excluded services would be appreciated. We are assuming that this change will result in the reduction of excluded services revenues to be deducted in order to arrive at the DPCR5 base price control revenue.

4.5 Use of System Bad Debts

Bad debt recovery is likely to become a more prominent issue over the remainder of DPCR4 and throughout DPCR5. The recession and the resulting impact on electricity usage are likely to increase the likelihood of a small or medium sized supply business failing. We acknowledge and are in agreement with the comments made by Ofgem

on the treatment and methodology for the recovery of bad debts incurred in DPCR4. We also agree that for materiality reasons, any DPCR5 bad debts should be logged up.

4.6 Financial Model

ENW recognise the progress made by Ofgem in adopting changes to the financial model to reflect discussions since the Initial Proposals. However, many new issues have been identified in the latest version of the financial model released as part of the October update; many of the errors we have identified result in very material reductions to ENW's revenues. This therefore gives ENW cause for concern over the robustness of the Ofgem financial model and its ability to deliver accurate price control revenues for DPCR5. We will continue to provide comments and any help we can to improve the accuracy of the model.

4.7 Allowed Revenue Presentation

It has to be recognised that changing the pattern of prices for customers is not desirable and it is sensible to choose a profile that provides some stability and that can be more easily explained to customers.

We firmly believe that revenues at DPCR5 should follow a Po/X real price profile as used for DPCR4, subject to financeability constraints on the DNOs and stress testing through the financial model. If X is set to zero then prices after 2010/11 will be stable and follow RPI in nominal terms. This approach is also close to the method that matches revenues to costs, would be consistent with the last price control and is already understood by customers.

4.8 Transaction Costs and WACC

These comments are included in response to a specific issue discussed in the bilateral meeting between ENW and GEMA on 7 October 2009.

Work carried out by NERA on behalf of DNOs through the Energy Network Association provides evidence on transaction and pre-funding costs associated with the raising of debt finance. The detailed analysis is contained in section 6.4 pages 29 to 30 of the document "NERA report on the Cost of Capital for DPCR5", distributed as part of the Initial Proposals documentation.

In summary, the work carried out by NERA indicates that transaction costs and pre-funding cost equate to an additional amount on the cost of debt of 15 basis points on a historical basis and 60 basis points on a current basis. This is identified as a real cost to the DNOs, requiring explicit funding at DPCR5. NERA also indicate that around 70% of debt will be embedded debt during the DPCR5 period and 30% will be new debt. NERA assume that the current economic conditions will prevail for 50% of the DPCR5 period and therefore weight the 60 basis point impact of transaction and pre-funding costs on the cost of debt at 15% (50% of 30%). This therefore computes a

transaction and pre-funding cost of 85% x 15 basis point (historic potion of embedded debt) + 15% x 60 basis points (current portion of new debt) = 21.75 basis points.

The work carried out by NERA supports to a large degree the experience of ENW with regard to transaction costs associated with the raising of new debt finance. ENW recently issued a 12 year bond and incurred transaction costs equivalent to an additional 14 basis points cost per annum on the issue. In addition current standby facilities available to be drawn down on demand equate to a further 6 basis point cost on the overall debt portfolio per annum. These two combined factors equate to an overall 20 basis point uplift on the cost of debt. In this transaction pre-funding costs were lower than average due to the bond raising additional funding rather than replacing existing debt.

4.9 Pensions Methodology (Annex 1)

The responses below are based on the "marker" information provided in Ofgem's letter of 5 October however we note that the pensions consultation regarding the funding of pensions in DPRC5 is still to be concluded.

4.9.1 Calculation of Deficit Funding

Ofgem state in the October letter that the size of each company's pension scheme deficit has been reduced by 28% to allow for improving market conditions since the valuation estimates as at March 2009. However, ENW's deficit figures in FBPQ table F7 are based on the last full triennial valuation of the pension scheme, conducted as at 31 March 2008 and showing a deficit of £106.7m. This figure has then been erroneously scaled back for the deemed market improvements since March 2009.

An updated actuarial valuation of the scheme at March 2009 has been provided to Ofgem (included in table 7a of the FBPQ) and shows the total deficit at £245.7m i.e. £139m higher than at March 2008 and that included in the FBPQ submission. It is therefore incorrect to apply the 28% reduction factor to our FBPQ deficit payments which are already well below the potential deficit at 31 March 2009.

We have taken a prudent view of our pensions deficit repair payments over DPCR5 and the only deficit repair payments included in the submission are those that have been agreed with the Trustees to repair the deficit as at 31 March 2008 (£106.7m). This deficit is being repaid over a period of 11 years from that date. We strongly believe that we have done all we can to reduce the cost to customers in DPRC5 of funding the deficit repair and that the proposed repayment profile must as a minimum be funded in line with the agreement with the Trustees. Funding must be done on a consistent basis across all DNOs.

4.9.2 Ongoing Service Costs

Ofgem propose that ongoing pension costs (excluding excluded services and sole use connections pension costs) are to be funded after the application of an assumed IQI rate of efficiency. The IQI percentage is calculated on a cost base that excludes pensions and therefore it is not appropriate to apply this assumed efficiency to

ongoing pension contributions. The drivers for pension costs are very different to the other costs included within the IQI efficiency calculation. Labour costs are a small proportion of this cost base and therefore it is not reasonable to extrapolate this efficiency measure to pension costs. Given the acknowledged requirement for workforce renewal it is unlikely that DNOs would seek to secure material savings via headcount reductions. Even if DNOs were to achieve efficiencies through direct headcount savings, such savings would have minimal consequential reduction in pension costs.

The calculations in the financial model that accompanied the update letter also include an error in double counting this efficiency percentage. The scaling down of the pensions contributions by 88.1% is included in the "tax pensions" tab of the model. A further IQI "scaling factor" of 90% has then been erroneously applied in the pensions allowance calculation. There are also further erroneous adjustments to scale costs back for non distribution activities. We expect these adjustments to be corrected before the Final Proposals.

4.9.3 Pensions Admin Costs

The pensions admin costs submitted in the FBPQ have been significantly scaled back in the October update. The application of caps to the variable PPF levy and the scaling factor disallow £11.9m of pensions administration costs over DPCR5. (77% of the total)

The scaling factor has been incorrectly calculated in the October update letter and we believe the calculation should allow around 90% of costs as opposed to 23% currently being allowed. This matter is being picked up separately with other modelling issues through a meeting with Ofgem on 22 October.

We have worked with our actuaries to provide estimates for the PPF levy in the DPCR5 period as included in the FBPQ submission. We are also continuing to work with our service provider to manage the D&B ratings that are used as the basis for the risk based element of the PPF levy and are strongly incentivised to do so from a cash flow perspective. The D&B failure score for UUES has recently improved to 77. As a result of this we now believe the PPF levy will be £0.9m per annum (2007/08 prices) throughout DPCR5. This does not affect our forecast payment for 2009/10 of £2.6m which covers the last 2 years of DPCR4.

Ofgem have provided to us some analysis of the fixed and variable PPF levies forecast for DPCR5 across the DNOs. A number of the DNOs had a £nil forecast against both the fixed and variable elements. We have consulted with our actuaries and based on publicly available information in the GAD report, we believe that every DNO should have a scheme-based levy cost and that the majority will also incur a risk-based levy cost. PPF levy expenses may be paid either directly from the pension schemes or by the employer. We are concerned there may be a difference in treatment which affects Ofgem's efficiency assessment of these costs, depending on which payment method is used.

4.9.4 DPCR4 True up

The DPCR4 true up calculations that have been provided to us do not fully fund the PPF levy for 2008/09 and 2009/10 (both expected to be paid in 2009/10) or the administration costs incurred by the scheme for these years. Both of these costs should be included in this calculation. These are legitimate costs associated with running the pension schemes. The DPCR4 final proposals were clear regarding the treatment of the PPF levy. Para A1.45 states: "*In considering actual pension contributions, the relevant amounts will be actual cash contributions attributable to the distribution business and paid into the relevant pension scheme. Where relevant, this will include statutory contributions the Pension Protection Fund.*"

The true up calculation also incorrectly states the additional £2.5m deficit repair payment made in 2009/10 as £0.6m. The payment is being made in relation to the triennial actuarial valuation deficit at 31 March 2008.

In DPCR4 any PPF levy and admin cost adjustments made should be treated through the pension true-up mechanism. We do not agree that an adjustment should be made to the actual spend on PPF levy and admin for 2009 in the RAV roll forward.

In preparation for the meeting on 22 October we have confirmed the correct figures in the true-up normal, deficit, PPF levy and admin costs.

September Update Response

5 Network Cost Assessment

5.1 Overview

Whilst we are pleased to note that Ofgem recognise more work is required to complete the analysis of connections costs, it is worrying that there is so little time left to correct this analysis before the Final Proposals. There is clearly an inconsistent data set if companies are reporting wildly different numbers of units that are orders of magnitude apart in Ofgem's current cost analysis. We suggest below how appropriate changes could be made, and encourage Ofgem to make these changes as a matter of urgency.

5.2 Customer Specific Demand Connections

We have identified a number of material flaws in the methodology that Ofgem have used to calculate DNOs' connections allowances. The approach proposed by Ofgem within the September updates results in inadequate allowances for ENW. Allowances have been set based on an inconsistent data set following a methodology that disadvantages DNOs that have facilitated competition in connections within their operating area.

5.2.1 Data issues

The analysis undertaken by Ofgem is based on new data reporting formats introduced for the FBPQ. As with the introduction of many new reporting requirements, definitions have been interpreted differently by different DNOs. These inconsistencies of interpretation are compounded by the fact that DNOs have not recorded activities against these definitions historically and therefore have to base their submissions on samples of jobs.

There is clear evidence in the document of DNOs having interpreted Ofgem's new definitions differently, for example:

- For LV end connections involving HV work ENW forecast 452 connections whereas SSE Southern forecast 15,945
- For low volume high cost connections SP Distribution forecast 7 connections whereas SSE Hydro forecast 1,575
- Across all high volume low cost activities, EDF LPN forecast 1,557 connections whereas SSE Southern forecast 32,718

It is essential that Ofgem undertake analysis to ensure that all DNOs are forecasting on the same basis before calculating allowances based on comparative data.

It is also important to recognise that DNOs were asked by Ofgem to complete their submissions based on a sample of projects undertaken in 2008/09. There is potential for individual sample sizes to be too small to provide statistically significant results; there only need to be a few projects requiring significant reinforcement to be included within the sample to distort percentages applied in making submissions.

It is clear that, in some areas, we have interpreted definitions differently from other DNOs. In analysing the relative data of different DNOs we have recognised that we have categorised LV connections with associated EHV work differently from most other DNOs by categorising such jobs within a category that Ofgem models within High Volume Low Cost activities, whereas other DNOs have categorised them within Low Volume High Cost activities. The element of EHV shared cost included in these categories materially contributes to the relatively high unit costs presented for high volume work in Ofgem's document. We have identified the costs (and associated customer contributions) that are associated with these jobs and propose moving them to be categorised as Low Volume High Cost activities.

5.2.2 Ofgem's methodology

We have a number of issues with Ofgem's methodology for calculating baselines.

- Ofgem have not included ICP volumes in calculating unit costs or allowances. This penalises DNOs in areas such as ours where competition in connections is more prevalent. Failure to acknowledge ICP volumes also risks inappropriate distortions in DPCR5 volume driver mechanism as DNOs who lose market share to ICPs would not be funded for associated reinforcement; such an approach might discourage facilitation of competition in connections.

- Ofgem cherry-picks benchmarks across categories of expenditure. For example several companies are seen to be below benchmark in one area of analysis but above benchmark in another, for example EDF EPN and both SSE companies are below benchmark on all high volume activities but above benchmark on low volume activities. Such an approach, combined with recognised reporting consistency issues, cherry-picks benchmarks.

5.2.3 Reasons for differences in unit costs

Ofgem's analysis fails to recognise that there are a number of reasons why DNOs may forecast different levels of connections-related unit costs. For example:

- Ofgem have not taken into account the difference in the ratio of sole use jobs to shared use jobs in each DNOs area. In calculating unit costs including both sole and shared use connections Ofgem have ignored the effect of the relative differences in proportions of shared use connections between DNOs. This will distort unit cost calculations and disadvantage DNOs who incur higher proportions of shared use connections.

- DNOs that connect a higher proportion of commercial customers relative to domestic customers (for example because of increased ICP penetration within

their operating area) will generally report higher unit costs as fewer customers are connected per average project.

- After removing "LV connections with associated EHV work" ENW's "LV end connections with HV work" unit cost remains high compared with the information on other DNOs circulated by Ofgem. We consider this to be due to the vast majority of this work being commercial rather than domestic projects. Competition in the North West has been most active in the domestic markets where multi-utility providers have been the norm. ENW have carried out largely commercial connections (over 70% of projects) and these have generally only one to three MPANs connected per project. We believe that this mix of work may be significantly affecting the calculation of the unit cost. Analysis of our unit costs shows the unit cost for domestic projects is £1k for LV with LV and £6k for LV with HV, whereas for commercial projects is £4k for LV with LV and £28k for LV with HV. We recommend that Ofgem take the ratio of commercial to domestic projects into account in calculating benchmark unit costs, possibly by applying separate unit costs for each type of project.

5.3 Rising and Lateral Mains

Many high rise buildings and deck-access flats in our network area have been demolished or refurbished in recent years, which has provided the opportunity to remove or review/refurbish the service arrangements. We have not to date had experience of significant problems with rising or lateral mains and have focussed our investment on other areas where the need has been demonstrated to be of higher priority. We do however recognise that it will probably be necessary in some instances to carry out replacement or refurbishment of some of these assets before major work becomes due on the buildings where they are located.

We have not included any forecast costs for rising and lateral mains in DPCR5 but plan to carry out surveys of installations and develop an appropriate asset model as an extension of Condition Based Risk Management during DPCR5. Ownership of, and responsibility for, existing assets is varied and not completely clear in every instance at the present time. We intend to resolve such issues as part of the survey process and are working with the ENA to develop more appropriate ownership and operational arrangements for any new multi-occupancy building.

We suggest that the proposal to allow DNOs to recover costs via a reopener is sensible but suggest that this should not be constrained by an arbitrary timeframe as establishing responsibilities and therefore liability will not necessarily fit around a regulatory schedule. Ofgem must also consider that DNOs may not have the ability to absorb the resources to identify liabilities proactively following the significant indirect cost cuts suggested by the October update letter. As such, we expect that inspection costs and legal work will also need to be covered by the re-opener mechanism. The potential magnitude of liabilities suggests that a reopener should instead be triggered once a materiality threshold has been breached.

5.4 High Impact Low Probability (HILP) events

We again note Ofgem's concerns with regard to discrimination across the customer base in respect of security of supply and who should pay for the increased resilience. However, the focus of the ENA HILP work centred upon the GVA value of the demand area to the economy of the UK, demonstrating that it is not just those energy consumers located in Central Business Districts (CBD) that benefit from increased resilience. CBD consumers contribute disproportionately to the economic health of the wider region, as well as providing a range of essential services themselves. We believe that all customers should pay to avoid the costs of social breakdown that would accompany a CBD HILP event. This was a point strongly made by many of our stakeholders, and was the underlying driver when BERR (as was) first raised the issue with the industry. We believe that increased resilience to address societal risk should be paid for by all customers. We believe that Ofgem have accepted this proposition for flooding; we are perplexed that the same logic is not extended as appropriate for other similar risks.

Our stakeholder feedback confirms there is general appreciation and acceptance of the value of providing superior security of supply to our CBD areas. It is further noted that Regional Resilience Teams believe that the current definition of CBD is too narrow and needs to consider densely populated areas that surround the CBD and the societal impacts of major loss of electricity supply on these areas.

We remain frustrated that the key underlying policy issues appear to remain unresolved, and we would urge that Ofgem and DECC take this debate forward, not just for London, but with a clear eye on the wider societal risks for GB.

5.5 BT 21st Century Network

We note Ofgem's proposed treatment of BT21stCN costs and consider it an appropriate response to the current uncertainties regarding future provision of services from BT.

As discussed in detailed responses to Ofgem, we have assessed the long-run cost of different options including progressive deferral of planned investment. This analysis shows that there is a significant downside in deferring expenditure due to the forecast increases in operating costs that would be required to sustain the legacy services. We also believe that there are further significant risks in longer term deferral as follows:

- The BT economic test for the provision of the service means that there are no assurances of service being extended to 2018 regardless of service take up or DNO need.

- BT solution delivery is currently uncertain and unproven.

- Delivery in DPCR6 is higher risk due to predicted increases in asset replacement volumes making outage availability uncertain.

- Our Customer Provider's (Cable and Wireless) view on BT's proposal is that for a variety of reasons BT are unlikely to honour the 2018 date or their stated service prices until then.

In order to mitigate these risks and for the reasons explained in our previous answers we will continue with our mitigation project in DPCR5 and therefore continue to forecast expenditure on this basis.

We note Ofgem's reference to the recent information request on unit costs. We would urge caution in such analysis as there is a limited degree of comparability between DNO proposals due to the significantly different legacy positions that apply, and the unwillingness of BT, through the Customer Providers, to provide individual costs for alternative service provision to our required specifications.

5.6 Critical National Infrastructure (CNI) protection

We have not included any expenditure for the protection of critical national infrastructure within our DPCR5 submission; however we are concerned by the proposed funding mechanism for CNI as a precedent for future uncertain investment programmes. The proposal as it stands suggests that a DNO could tender the project competitively and complete it efficiently but would still be unable to recover the full expenditure. We would urge Ofgem to confirm how it derived the 95% efficiency cap (given that the expenditure must be competitively tendered and will be subject to an ex-post efficiency review). We believe that this treatment may conflict with Ofgem's statutory duty to finance an efficient company. It would only be appropriate to adopt a reduced pass through rate if a DNO is unable to demonstrate that it has competitively tendered and positively engaged with stakeholders.

The proposal to fund 95% of the efficient expenditure exposes a company's returns asymmetrically to more downside than upside risk (in an area where the magnitude of the costs are unknown). This is likely to skew expected returns and will have implications for the company's ability to retain and attract equity finance.

5.7 Black Start Capability and Emergency Batteries

We note the recognition of the forthcoming recommendations of the ETG to the Energy Emergency Executive Committee (E3C) and agree that it is appropriate to await these before assessing this issue. As such, we have not considered in detail all the potential implications of the standard that would eventually be produced and agreed. Although we do not have any Black Start contracts, the need to re-connect customers after the stabilisation of the transmission network will still require our network to comply with the requirements of the standard.

We currently see that there are potentially four areas of the operational infrastructure that the standard may impinge upon, these being:

- Control Centres

- Telemetry Communications

- Substation RTUs

- Substation plant and auxiliary supplies

We will shortly complete investment to ensure longevity of power supplies to our main and standby control centre locations for up to 72 hours and do not anticipate that the proposals will drive further investment in respect of this specific issue. However, we may have further investment requirements which cannot be identified until agreement on the standards has been reached.

Within our communications system there are a number of radio and other sites supporting Black Start, for which our design standard is to install up to 72 hour resilience. As we are proposing to carry out work at these sites as part of our BT21stCN mitigation programme, we believe it is appropriate to make further investment at these specific sites at marginal cost at this time. We have not included any additional investment in this area at this time due to the lack of clarity for Black Start requirements.

Our Operational IT submission detailed the separate investment required to establish a substation data network which will provide Black Start resilient telemetry to our substation sites; being those sites where we would require to carry out restorative switching up to 48 hours into a Black Start scenario. Any requirement to increase either the number of Black Start switching sites and/or the Black Start resilience period to 72 hours would require additional investment to increase battery capability for interim communication nodes, Black Start substation site communications and RTUs.

For substation locations, we are aware that there is potentially additional significant investment needed to provide up to 72 hour resilience associated with protection and trip and closing systems operating at 50V DC, 110V DC or other voltages. As the definition of sites that may require intervention has not yet been agreed we have not identified these sites specifically nor have we attempted to estimate the costs of compliance. Additionally we are not yet convinced that investment is necessarily the correct way to address these issues and there could be a number of operational responses that bear further investigation before we embark on the investment route.

5.8 Flooding

We are pleased to note that Ofgem have incorporated the changed risk levels resulting from investment into their analysis, and that our FBPQ forecast is now proposed to be fully funded. This has addressed our concern that the simple econometric test in the IP disadvantaged sites at significant risk but that only served small numbers of customers.

We will continue to monitor improvements in flood risk data (eg covering flash flood risk, which is not currently available) so that future flood risk can be better managed.

5.9 Technical Losses

We note that the assumed losses incentive rate used for assessment of DNO proposals remains unchanged from the value in the Initial Proposals (£60/MWh) and that our proposals remain valid at this rate. We agree that this is an appropriate rate for assessing the value of technical loss savings, designed to price the externality for real carbon reducing activities. This rate would be appropriate for the implementation of an input-based incentive scheme, as proposed by the DNOs.

However this does not alter our argument that a lower strength incentive rate is appropriate for an output-based incentive, as proposed by Ofgem. This scheme is focussed on tackling theft and dataflow management, and is also subject to significant levels of risk, arising from issues outside the DNOs' control. The high incentive rate simply increases risk in the output mechanism, and is unnecessarily high to incentivise activities which do not in themselves drive carbon reduction. We continue to propose that for the output incentive, the rates should exclude the shadow price of carbon.

We await confirmation that, in target setting, Ofgem will apply the projected loss assumptions from the projected time of project commissioning rather than Day 1 of DPCR5.

5.10 Discretionary Expenditure

We note that Ofgem are considering the possibility of starting the WPD substation smart metering project as ex-ante discretionary expenditure, in advance of the first call under the LCN fund. We assume that this proposal will just cover the funding necessary to take the project forward to an appropriate stage, and that subsequent funding will be made in competition with other submissions under the LCN fund.

5.11 Questions

Question 1: Do you consider the volume drivers proposed for customer demand connections to be appropriate?

Our response is contained within section 2

Question 2: Do you consider the proposed reopener for low volume, high cost connections and general reinforcement appropriate? Is it set at the right level?

Our response is contained within section 2

Question 3: Do you agree with the proposed mechanisms (reopeners/logging-up) for dealing with uncertain costs?

Our response is contained within section 4

Question 4: Do you agree with our proposed methodology for setting flooding expenditure allowances for DPCR5?

Our response is contained within section 1.8

6 Network Investment Policy

6.1 Overview

The detailed comments relating to individual reopeners and logging up mechanisms, set out in this section, should be read in conjunction with our general comments in Section 4 of this response document.

6.2 Application Window for Reopeners

Price control reopeners are a useful tool where there are significant levels of uncertainty surrounding a potential business requirement, by introducing a degree of flexibility into a price control. By setting application windows, some of this flexibility is eroded. Whilst we accept that there are some practical considerations surrounding reopeners (namely the resource implications for both Ofgem and the DNOs) which makes application windows desirable from a planning perspective, the rationale behind the overall reopener mechanism is to provide protection for both customers and DNOs because the timescales and scale of a specific issue are uncertain at the time of setting the price control. To attempt to dictate specific timeframes based upon the same uncertain information would appear to restrict the ability of the mechanism to fulfil its purpose.

In the case of the Traffic Management Act, Ofgem is proposing a reopener two years into the price control but requires a minimum of 12 months of data to allow an adjustment. This means that if permitting schemes are not implemented in the first 12 months of DPCR5, all associated costs will be logged up and recompensed at DPCR6. We suggest that DNO management have very little influence over the magnitude of the charges and Ofgem should therefore adopt a low materiality threshold for the reopener to protect companies from increases.

We suggest that an annual reopener call would be the most appropriate way of allowing Ofgem and the DNOs to allocate resources appropriately whilst maintaining the intended flexibility of the mechanism.

6.3 Traffic Management Act (TMA)

Our Asset Service Provider, UUES, has undertaken significant steps to understand and plan for the Traffic Management Act.

Future costs associated with the TMA and the New Roads and Streetworks Act are a mixture of certain and uncertain costs. Given the uncertainty as to the basis on which permitting will be implemented in local authority areas, we agree that it is sensible to ask DNOs to re-state forecast costs against a consistent set of assumptions and to introduce a mechanism to increase revenues if circumstances change.

6.3.1 Data issues

Whilst we support Ofgem's attempts to ensure that all DNOs are reporting costs on an equivalent basis we are concerned that disproportionate effort is being focussed on this small sub-set of costs to the detriment of other, more material, aspects of expenditure.

6.3.2 Ofgem's methodology

We have a number of issues with Ofgem's methodology for calculating baselines. In a number of areas Ofgem cherry-pick benchmarks, creating artificially harsh overall benchmarks.

- Ofgem provides no evidence to justify their assumption that no more than 5% of notices and no more than 10% of inspections will incur penalties. The fact that only two licensees are given their forecast costs suggests that these levels are more stringent than upper quartile performance. We suggest that Ofgem should set targets allowing some reward for best performance as well as setting an incentive for other DNOs to improve performance.

- Ofgem provides no benefit to DNOs who plan to outperform the assumption that 90% of noticing penalties will be paid at discounted rate. This gives no incentive to DNOs who strive for lowest cost – indeed it simply ensures that those DNOs whose allowances are set at 100% discounted rate face only downside risk. Allowances for all DNOs should be set assuming 90% of noticing penalties paid at discounted rate to give some incentive for outperformance.

We agree that it is sensible to include administration costs within EMCS costs and to set baselines based on combined analysis; the issues of definition differences between DNOs mean that there is a risk of cherry-picking if administration costs and EMCS are modelled separately and separate baselines chosen.

6.4 Reopener for Load Related Expenditure

We are pleased that Ofgem is considering addressing load related volume uncertainty and broadly agree that the proposed mechanisms are appropriate. In particular, a starting point of expenditure forecasts removes the potential for revenue adjustments being made on the basis of application of a mechanistic driver metric, and takes into account a DNO's ability to mitigate the impact of such changes within its network programme. The ability to reopen the settlement based on an ex-ante expectation as well as ex-post expenditure is also welcome.

There remain however many questions regarding the scope and definition of the proposed process, and we hope that Ofgem will consult further and specifically on this item. It is not explicit whether this reopener applies separately to general reinforcement and the shared element of Low Volume High Cost connections or if the reopener applies to the aggregate amount of the two forecasts. This needs to be clarified as the two components are subject to significantly different levels of uncertainty and DNO control. As such, we propose that the Low Volume High Cost

connections re-opener should have a narrower materiality band around the baseline than that for reinforcement, and that Ofgem should ensure that increases above the respective threshold in either category can act as the trigger for re-opening.

With regard to the review of outturn demand, this will need to be carefully conducted to ensure that only those aspects of demand that drive investment are reviewed. It is not clear for instance whether Ofgem will consider a disaggregated (eg by BSP) demand forecast or an overall forecast as reported in the FBPQ and RRP. A disaggregated forecast should be used on the basis that reinforcement responds to individual load increases and where load decreases we would not spend money to remove assets. We would also question the reliance on LI indicators to determine the validity of requests and stress the importance of a wider dialogue on changes to macro factors that have given rise to the re-opener being triggered.

It is important that the mechanism rules do not preclude DNOs from applying, thereby failing to mitigate the associated risk and requiring a compensatory WACC uplift. This is a similar issue to the potential restrictions caused by application windows.

6.5 Logged Up Expenditure Items

Ofgem should not use logging-up mechanisms for expenditure items of a material level as this has financeability implications for the DNOs. The DPCR5 DNO financial ratios are likely to be stretched given the proposed settlement in the Initial Proposals (which we believe is inappropriate and must change). This is compounded by the fact that Ofgem do not target the DNO key ratio of PMICR which is a key measure used by banks and credit rating agencies alike. Any uncertain but potentially material obligations should be protected through reopeners. Ofgem should use the logging up mechanism where there are uncertain obligations of a minor scale. The introduction of outputs into DPCR5 has brought some benefits but it must be recognised that they have removed some flexibility to amend investment plans. The introduction of a logging up mechanism could reintroduce some of the flexibility where Ofgem agree that expenditure is appropriate. We therefore agree with Ofgem's suggestion that where logged up expenditure becomes material it will reopen the price control.

6.6 High Volume Low Cost connections driver

Whilst we agree in principle that the proposed driver is an appropriate way of covering off excessive connections volume risk in DPCR5 given the current uncertainties over future market conditions, the mechanism will be driven by a unit rate of connection derived from the data used to set base allowances. As discussed elsewhere in our response, we do not consider that this data is currently sufficiently robust or well-understood to adequately perform this purpose. Ofgem have been less specific as to how the driver will work with respect to the actual levels of contribution for shared expenditure. Further clarity on the adjustments envisaged is required.

6.7 Transmission Exit Charges

In our response to Ofgem's Initial Proposals, we suggested that it is unnecessary and inappropriate for an incentive to be applied to the DNOs in respect of Transmission Exit Charges. We do not believe that the proposed incentive arrangement will deliver the desired behaviours. The reality is that the long lead times associated with new GSP schemes mean the choice of engineering solution is usually made in advance of the price control period when the investment is to be made. Thus, an incentive based on the estimated costs of actual schemes can only incentivise the efficient delivery of those schemes (which is within the control of NGET rather than the DNOs) and not the choice of engineering solution, which the DNOs can and already do influence.

The Ofgem intention to introduce an incentive mechanism requiring DNOs to expend more indirect costs in monitoring and negotiating with NGET is in direct conflict with the approach to setting indirect cost allowances, which drives DNOs to minimise such costs and only provides funds associated with the most minimal level of activity by the DNO groups.

As stated in previous responses, exit charges are largely outside the control of DNOs, and the annual charges can be volatile especially when new or reinforcement assets become chargeable. This makes it difficult for DNOs to forecast ahead accurately, even when contact with NGET is frequent. Such volatility has the potential to create windfall gains and losses within the incentive, rather than achieving Ofgem's desired effect.

We suggest that given the significance of the remaining outstanding areas of the price control and the relative immateriality of the DNOs' ability to influence exit charges, that Ofgem monitor the proposed DPCR5 schemes and work with both NGET and the DNOs to understand any variances to the DPCR5 proposals.

6.8 Questions

Question 1: Do you consider our proposals for an application window to be appropriate?

Our response is contained within section 2.2

Question 2: Do you consider our proposed approach for TMA costs to be appropriate?

Our response is contained within section 2.3

Question 3: Do you consider our proposals for assessment of the load related reopener to be appropriate?

Our response is contained within section 2.4

7 Financial Issues

7.1 Recovery of Bad Debts

Bad debt recovery is likely to become a more prominent issue over the remainder of DPCR4 and throughout DPCR5. The recession and the resulting impact on electricity usage are likely to increase the probability of a small or medium sized supply business failing. ENW acknowledges and is in agreement with the comments made by Ofgem on the treatment and methodology for the recovery of bad debts incurred in DPCR4. We also agree that for materiality reasons, any DPCR5 bad debts should be logged up.

8 Use of Reopeners, Logging Up and Hybrid Mechanisms

8.1 Overview

We have consistently suggested that Ofgem should use regulatory mechanisms to manage the DPCR5 risk exposure to levels commensurate with those at DPCR4. We have noted a significant increase in perceived tail end risk since the DPCR4 settlement and suggest that managing these additional risks through appropriate mechanisms will provide the most efficient outcome for customers.

In this regard, we recognise that revenue drivers are useful when there are significant volume volatility issues. Reopeners are useful where the timing or scope of a responsibility is uncertain. The main danger of employing these mechanisms is that they exclude the investment requirements from the financeability tests employed at the price control. Our further concerns relate to the possibility of the usefulness of the mechanisms being unduly diminished by inappropriate application restrictions being placed upon them.

8.2 Overall Risk Mechanism

In our Initial Proposals response, we included a report by Oxera which assesses the scale of the volatility in DPCR5 compared against the same metrics in DPCR4. The report concludes that the events since the 2004 price control have created a rational basis for a heightened perception of tail risk. The introduction of reopeners and logging up mechanisms recognises the specific issues relating to uncertain expenditure but does not address the wider risk issues. We believe that Ofgem should replicate the Ofwat substantial effects clause into the price control to provide investors with a formal route to apply for a reopening of the price control, subject to specific conditions.

We suggest that Ofgem should formalise its duties in a substantial effects clause to provide DNOs with some protection against unforeseen cost shocks. This clause should also provide some comfort to investors as DNOs could have a route to appeal to the Competition Commission if Ofgem fails to discharge its duties to finance an efficient company appropriately. We believe that the clause should not include a percentage revenue test within the mechanism, retaining the flexibility for Ofgem to make a case by case determination of whether the effects of a particular situation are substantial.

8.3 Application of Risk Mechanisms

Ofgem's perception of the risks associated with the incorporation of uncertainty mechanisms is inappropriately biased against the DNOs. DUOS charge volatility is a supplier-led argument and fails to recognise the benefits provided by risk mechanisms (in that the alternative would be to grant larger allowances for uncertain expenditure or to compensate DNOs for inappropriate risk profiles with approximated WACC uplifts). We do not believe that it is appropriate to suggest that a risk mitigation tool should not be implemented due to lack of resources. We suggest that annual calls for

reopeners would balance the benefits of the mechanism with the administrative burden associated with them.

The proposed solutions to the perceived implementation risks may actually negate some of the benefits of the mechanisms; for instance, introducing smoothing adjustments will placate supplier concerns relating to charge volatility but will have cash flow implications for the DNOs and therefore cost implications for customers. It would be better to adopt a P0 and X approach that ensures the most stable profile for suppliers and customers throughout the period.

The setting of application windows, materiality thresholds, and grouping of reopeners need to be carefully considered. We have concerns that the utilisation of the proposed windows may prevent DNOs from applying for reopeners, and suggest that an annual call for reopeners (similar to the Ofwat IDoK process would be more appropriate. We suggest that it may be appropriate to group reopeners on the basis that the mechanism is triggered by the breaching of either an individual trigger or an overall composite trigger (set at a level below the simple sum of the individual triggers).