

Electricity Distribution Price Control Review Final Proposals – Allowed Revenues and Financial Issues

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Target audience: Consumers and their representatives, distribution network operators (DNOs), independent distribution network operators (IDNOs), owners and operators of distributed energy schemes, transmission owners, generators, electricity suppliers and any other interested parties.

Overview:

Ofgem regulates the 14 monopoly regional DNOs to protect the interests of current and future consumers. We set a price control every five years. This sets the maximum revenues that each DNO can collect from customers at a level that allows an efficient business to finance its activities. We also place incentives on DNOs to innovate and find more efficient ways to provide an appropriate level of network capacity, security, reliability and quality of service.

The current price control expires on 31 March 2010 and Ofgem has now completed the Distribution Price Control Review (DPCR5) to set the controls for 2010-15. This is one of a series of technical papers that accompany the final proposals document also published today. It focuses on financial issues, regulatory asset values (RAV) and depreciation. It sets out our proposals for total revenue allowances for each DNO and explains how we have used the Return on Regulated Equity (RoRE) measure.

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This document is one of four more detailed, technical documents that accompany the DPCR5 Final Proposals. These documents set out the reasons, evidence, analysis and methodologies we have used in arriving at all of the decisions we have reached. These technical documents are targeted primarily at the DNOs and other stakeholders who require a more in depth understanding of our proposals and the rationale underpinning them in some or all areas. The DNOs have until 6 January to state whether they will accept these proposals. If any do not then we intend to refer the matter to the Competition Commission.

In December 2008 we published our Policy Paper. This focused on three key themes: environment, customers and network and set out our views on the overall approach to setting the control, our proposed methodologies, the structure of incentives and the new regulatory arrangements we considered appropriate.

In February 2009 all DNOs submitted updated forecasts for the final two years of distribution price control review four (DPCR4) and the five years of DPCR5. These were reduced from their initial level in August 2008, but still showed significant forecast increase in network investment and operating costs between DPCR4 and DPCR5. We identified significant issues with the forecasts and sought further information from DNOs to justify their forecasts.

In May 2009, we published our Methodology and Initial Results document, which set out details of our costs assessment methodology and initial results for a number of core cost areas. We explained that we would continue to develop our work in this area as we worked towards Initial Proposals.

In August 2009, we published Initial Proposals. We sought views on the outputs we expect and the behaviours we want to encourage from the DNOs and the mechanisms we propose to achieve them. We sought views on our initial view of the proposed revenues for the 2010 to 2015 period, and on the scope for shareholders to out or underperform our allowed rate of return within the price control period.

In September 2009, we published an update letter focusing on those areas of cost which we were not able to include in Initial Proposals because we required further information from the DNOs and other parties to form a view on the appropriate baseline revenue allowance.

In October 2009 we provided a written update to each of the DNOs on our view of allowed costs and revenues. We published these letters for stakeholders to consider.

While developing Final Proposals, we have taken into account views raised by stakeholders throughout the price control review. We have also continued to work closely with the RPI-X@20 review team, who are undertaking a root and branch review of the way we regulate electricity and gas, transmission and distribution networks in the future.


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- Electricity distribution price control review. Initial consultation document (32/08)
 - Update letter on the DPCR5 process (151/08)
 - Electricity distribution price control review. Policy Paper (159/08)
 - Electricity distribution price control review. Methodology and Initial Results Paper (47/09)
 - Electricity distribution price control review. Initial Proposals (92/09)
 - Electricity distribution price control review. Initial Proposals - Incentives and Obligations (93/09)
 - Electricity distribution price control review. Initial Proposals - Allowed revenue - Cost Assessment (94/09)
 - Electricity distribution price control review. Initial Proposals - Allowed revenues and Financial Issues (95/09)
 - Cover note Electricity Distribution Price Control Review Initial Proposals – Financial Model 2010-15
 - Electricity Distribution Price Control Review - September Update to Initial Proposals
 - Electricity distribution price control review - October update covering letter.
 - Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues (13/09)
 - Price Control Pension Principles – Consultation document (120/08)
 - Open Letter: Price Control Pension Principles Questionnaire (December 2008)
 - Price Control Pension Principles – Second consultation document (96/09)
 - Price Control Pension Principles – Third consultation document (125/09)

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Summary

This document presents our decisions on those elements of the price control settlement we collectively refer to as 'financial issues'. These are: the cost of capital, regulatory asset value, excluded services, taxation and pensions. It also sets out the overall revenue allowances for each of the 14 DNOs.

The **cost of capital** is an important component underlying the base level of return (in percentage points) we allow an efficient company to earn on their Regulatory Asset Value. We set the allowed revenue at a level we think sufficient to attract and reward equity investors and remunerate debt for an efficiently financed and managed company delivering acceptable quality of supply and customer service. Based on our analysis of market evidence we estimate that in the DPCR5 period DNOs should be able to finance their business at a Weighted Average Cost of capital (WACC) of between 4.3 to 4.9 per cent, vanilla (3.7 - 4.3 per cent, post tax). In reaching our decision on WACC we have considered advice commissioned from PricewaterhouseCoopers (PwC) and responses to previous DPCR5 consultations. We have also taken into account conditions in the debt markets and the relevant risk factors affecting the cost of equity. We have set our spot position within this range taking into account the overall risk/reward balance of the DPCR5 package. We have analysed this using our return on regulatory equity (RoRE) measure and sense checked against our financeability tests. We conclude from all the evidence and analysis that the appropriate baseline WACC is 4.7 per cent, vanilla (4.0 per cent, post tax). We have also decided, following consultation, not to incorporate a re-opener trigger mechanism in relation to the cost of debt for DPCR5.

A DNO's regulatory asset value (RAV) is the value attributed to long-lived network assets that will deliver network services to customers over a number of years. The speed at which DNO investors recover their investment in these assets is determined by the assumed regulatory depreciation rate. DNOs allowed revenues in each price control period are set to allow efficient companies to earn a return on the value of the RAV at least equal to the WACC. In this document we set out the opening DPCR5 RAV position for each DNO with the basis of calculation and relevant assumptions. We also explain the changes from the opening RAV forecasts included in Initial Proposals. We confirm that in the DPCR5 period, 85 per cent of all efficient, relevant expenditure will be added to RAV for all DNOs, subject to the detailed reporting rules. Relevant expenditure excludes costs for business support, non-operational capex, excluded services and the provision of legacy metering equipment and data services. In addition we outline depreciation policies and confirm that normal pension costs will follow the treatment of underlying labour costs. Our approach to RAV should ensure that the "slow" money element of allowed revenue for each year of DPCR5 is at an appropriate level.

Excluded services are normal activities of the distribution business that are not remunerated by charges for use of system, data services or legacy metering. We set out our decision on the scope of excluded services in DPCR5 and explain the approach we have adopted to ensure that charges for excluded services are set at appropriate level and do not remunerate DNOs for costs which they are already recovering from customers through the main price control revenue allowances.

DNO's pay **corporation tax** on their profits and we factor the cost of expected tax payments into allowed revenues. In reaching our decisions on the treatment of tax costs we have taken into account issues of timing differences and the consequences of potential changes in tax legislation. The tax allowance we have set for each DNO reflects its opening and forecast capital allowance balances for DPCR5, including some changes from figures included in Initial Proposals. Having considered relevant information, including responses to Initial Proposals, we have decided that there should be a tax trigger to address relevant changes to tax legislation within the DPCR5 period. We have also decided to continue recording tax savings made by DNOs from higher gearing than that assumed in the price control and we confirm the adjustments we are applying in this respect for the DPCR4 period.

Like other employers DNOs incur **pension costs** in providing pension benefits to recruit and retain skilled employees. We set out our decisions on the funding of deficit repair payments and ongoing employer contributions in relation to defined benefit and defined contribution pension schemes run by DNOs. Our proposals have been informed by the thorough and lengthy consultation process we have been running on pension provision by all monopoly gas and electricity network operators since August 2008. The price control approach to pension costs for energy network operators needs to balance the interests of consumers, employees and other stakeholders. In our approach for DPCR5 we have maintained the 'six pension principles' which we have used since 2004 when carrying out price control reviews.

Pension scheme deficits represent an area of great uncertainty for many large employers and our decisions are intended to clarify the regulatory position for DPCR5. We are committed to funding the current deficits relating to defined benefit schemes as at 31 March 2010, attributable to the distribution business. We will use valuations provided to us as at 30 September 2009 and a 15 year notional deficit repair period to determine allowances for deficit repair in DPCR5 allowed revenues. We will apply a "true-up" in future reviews for any change in deficit levels between 30 September 2009 and the start of the DPCR5 period. We have fully funded the DNOs' projections of ongoing pension costs for all the types of pension schemes they offer without any efficiency adjustment. In DPCR5 these pension costs will not be subject to the IQI incentive scheme. Instead they will be subject to a separate incentive adjustment under which DNOs will retain 50 per cent of under spend relative to their forecast or bear 20 per cent of any overspend. We have also addressed other issues including those relating to scheme transfers and tax treatments.

We also set out the basis of our **revenue allowances and financial modelling**. The revenue allowances reflect our policy decisions on various aspects of DNO operations and service provision together with the rationale we have applied to satisfy ourselves that efficient businesses can be financed. We explain the financial modelling approach we have used and outline the way we have profiled revenue allowances across DPCR5.

We have decided to profile allowed revenues so that the annual increment (the 'X' value) is on a constant percentage basis. This will reduce the risk of significant changes in distribution charges at either the start or the end of the DPCR5 period. To ensure transparency we have published the Excel workbook containing the DPCR5 model with our Final Proposals.

1. Cost of capital

Chapter Summary

In setting price controls, we assume that some costs are recovered over a longer period of time, especially where expenditure is expected to provide benefits to customers over a number of years. DNOs are therefore allowed a return to finance costs that are not immediately recovered. This return appropriately balances the cost of debt and the cost of equity financing. We describe this as the Weighted Average Cost of Capital (WACC).

Introduction

1.1. The cost of capital is the financial return expected by investors - both debt and equity - if an efficient company is delivering an acceptable level of performance and service and meeting all of its statutory and licence obligations. Regulators typically make an allowance for efficiently incurred financing costs by calculating an allowed return on the value of the capital employed in the business (i.e. the RAV), at least equal to the company's Weighted Average Cost of Capital (WACC).

1.2. In our Initial Proposals we assumed - for modelling purposes - the WACC used at DPCR4, i.e. 5.55 per cent, vanilla (4.8 per cent, post tax) to allow us to illustrate allowed revenues.

1.3. We explained in the December 2008 Policy paper why the cost of capital is an important component of the review but is only one element that drives the overall financial performance of a company under the price control. Therefore, in DPCR5 we have used the Return on Regulated Equity (RoRE) measure as a tool in assessing an appropriate range of equity returns that investors will be able to earn from the package as a whole. The cost of capital is therefore only one of several components in that assessment.

1.4. To assist and inform our judgement on the cost of capital for DPCR5, we commissioned external advice from PricewaterhouseCoopers (PwC). In addition to proposing a range for WACC in DPCR5, PwC also performed an analysis of relative risk between our proposed DPCR5 package with both our previous electricity distribution price control - DPCR4 and our most recent price control, i.e. gas distribution - GDPCR - settled in December 2007.

Current market conditions

1.5. Since the publication of Initial Proposals, we have continued to monitor developments in the financial markets. While a degree of uncertainty arguably remains, in our view, recent market data indicates that both liquidity and stability have returned to the debt markets - especially for relatively low-risk borrowers such as electricity distribution companies. Credit spreads for both A and BBB-rated issuers have continued to fall while yields on risk free assets such as Index-linked gilts (ILGs) have also decreased (See

Figures 1.1 and 1.2). These falls have also been reflected in the primary bond markets with companies accessing long-term financing at rates comparable, or indeed lower than, pre-credit crunch levels.

Figure 1.1 - Evolution of ILG yields

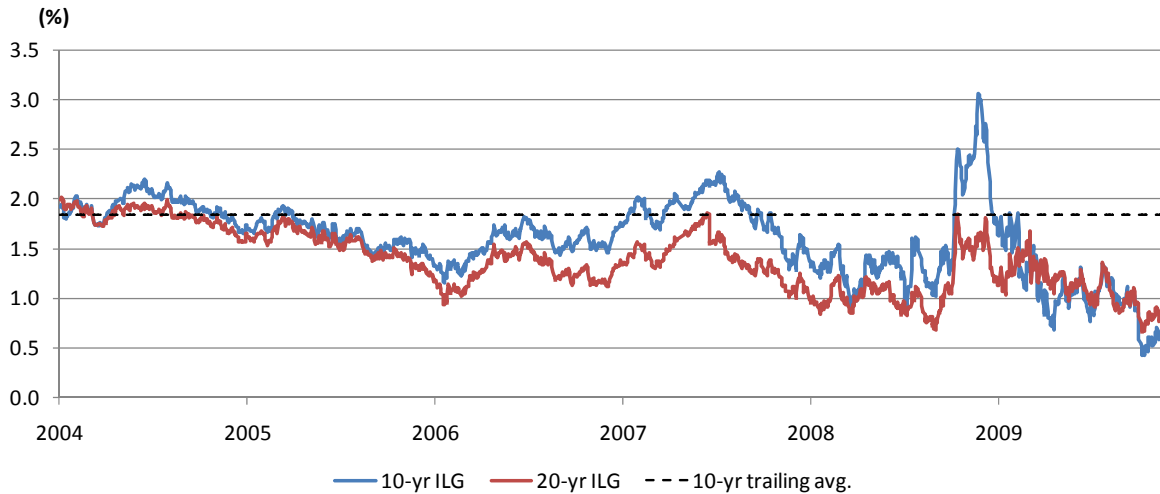
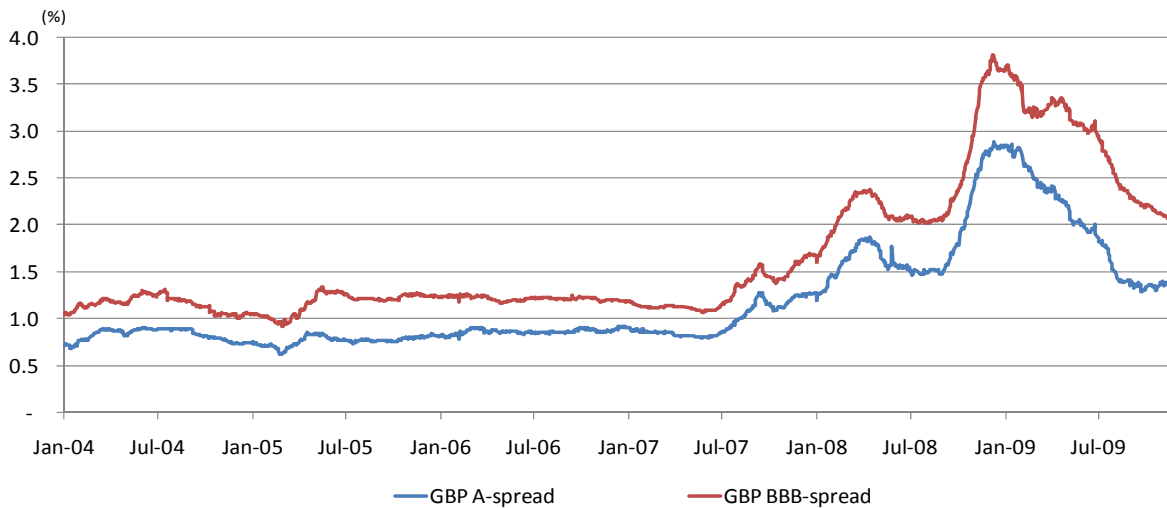
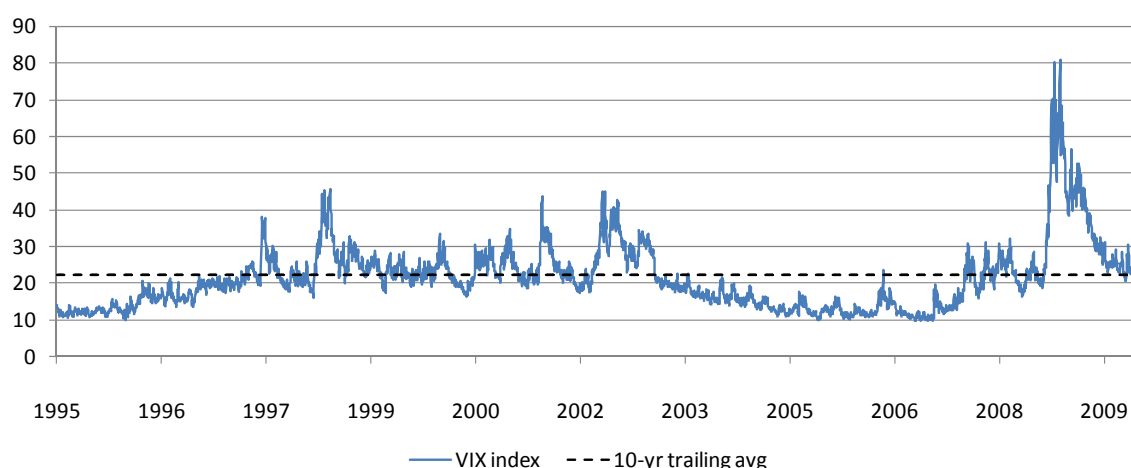


Figure 1.2 - Evolution of sterling credit spreads



1.6. The price of corporate debt has fallen in recent months and volatility has also decreased. A widely recognised measure - the VIX index (see Glossary) - indicates that forward looking volatility has reduced significantly since its peak in October 2008 - in the immediate aftermath of Lehman Brothers' collapse (see Figure 1.3). While current levels are not as low as during the benign conditions in the years prior to the credit crunch, they are comparable with the ten year trailing average.

Figure 1.3 - Evolution of the VIX volatility index



Respondent's views and the results of an Investors Survey

1.7. The DNOs broadly supported the analysis published by their economic consultants - NERA. These reports argued that in setting the WACC for DPCR5 we should adopt a higher cost of equity than at DPCR4 based on their Dividend Growth Model. NERA criticised the use of the Capital Asset Pricing Model (CAPM) as a means of estimating the cost of equity on the grounds that it produced too wide a range of results. On the cost of debt, NERA estimated the cost of historic debt by making reference to benchmark indices. For new debt, NERA estimated its cost by deflating the nominal coupon of bonds issued in 2009 and added an allowance (up to 60 basis points, bps) for its estimate of transaction (largely increased issuance) costs. These two numbers were then weighted according to NERA's estimate of the DNOs re-financing requirements in DPCR5 and the length of time "current conditions" will persist during the price control period.

1.8. Centrica submitted a report by CEPA that concluded that the WACC in DPCR5 could be up to 1 per cent lower than in DPCR4. CEPA said that the fall in risk-free rates had more than offset higher credit spreads and that during the financial crisis utility share prices had displayed lower volatility than the market as a whole. In addition, the price control package was likely to be lower risk than DPCR4. CEPA criticised the use of a Dividend Growth Model (DGM) to estimate the cost of equity on the grounds that it produced volatile and unreliable results. Furthermore, CEPA said that while debt transaction costs had likely risen, no explicit allowance needs to be made for fees as long as the cost of debt is set within reasonable levels. The various ranges proposed by consultancy companies are set out in Table 1.1.

Table 1.1 - Cost of capital ranges suggested by respondents and Ofgem's consultants

	NERA		CEPA		PwC	
	Low	High	Low	High	Low	High
Cost of debt	3.7%	3.8%	3.3%	3.6%	3.3%	4.0%
Cost of equity	7.3%	9.2%	6.5%	7.1%	5.2%	8.6%
Gearing	60%	60%	60%	62.5%	55%	65%
Vanilla WACC	5.2%	6.0%	4.6%	4.9%	4.1%	5.6%

1.9. A number of submissions were received from large electricity consumers or their representatives. They argued that PwC's range for the cost of capital was too high for companies facing such low risk.

1.10. Several responses were submitted by regulated utilities not subject to the DPCR5 price control. They suggested that PwC's proposed range was too wide and that only the top end was appropriate. One company pointed to its recent bond issuance as evidence that the cost of debt had risen.

1.11. For the first time in a Distribution Price Control, we were able to review the results of a survey of investors, conducted by the consultancy - Indepen. The survey was sponsored by the Distribution Network Operators (DNOs) and was steered by both the companies and Ofgem. The majority of the responses to the survey suggested that our Initial Proposals had had a neutral effect on the sector while others were more negative. On the cost of capital, respondents said that PwC's range was too wide and didn't reflect recent market evidence and volatility. Investors were generally positive about our approach to financeability while others suggested that additional metrics should also be considered. The results of the survey are available on our website.

Relative Risk Analysis

1.12. As part of the decision process on cost of capital, we commissioned PwC to assess the relative levels of risk faced by investors in electricity distribution versus gas distribution. This report concluded that there is some evidence to suggest that electricity distribution is less risky than gas, but we do not believe that their analysis is sufficiently detailed to quantify the difference.

1.13. However, in setting the cost of capital for DPCR5, we think the appropriate starting point is the cost of capital we set at the last price control review we carried out - the Gas Distribution Price Control (GDPCR) in December 2007. This was the last time we assessed relevant market evidence on the cost of debt and equity and is a more appropriate starting point than the last distribution price control review (DCPR4) which was completed five years ago.

1.14. As part of the consultation process on our Relative Risk Analysis, we received a joint submission from six of the seven DNO groups through the Energy Networks Association

(ENA). This document said that in the areas of costs, the regulatory framework and external factors, risk was higher in DPCR5 versus DPCR4 and should be compensated through a higher cost of capital.

1.15. We considered the ENA analysis carefully but concluded that we did not think it was balanced nor did it fairly represent the overall change in risk balance between the two price controls.

1.16. We have set out our own assessment of the relative risk where we have attempted to quantify objectively the relative risk of the two price controls. We analysed the relative risk of DPCR4 versus DPCR5 by considering the plausible RoRE ranges under both packages. For the DPCR4 analysis, we have calculated the maximum RoRE effect of each driver (be it positive or negative) achieved by a DNO and assumed that it could have acted in either direction. The potential range is therefore shown symmetrically. For the DPCR5 analysis, the minimum and maximum variances in RoRE are largely known in advance because of the caps and collars we have introduced. The results are shown in Table 1.2 below.

Table 1.2 - Relative Risk of DPCR4 vs. DPCR5 using RoRE

RoRE Driver	Treatment in price control		DPCR4: WACC - 5.545%		DPCR5: WACC - 4.7%	
	DPCR4	DPCR5	DPCR4 experience		Ex-ante	
			Min	Max	Min	Max
-Op-ex (100% incentive rate)	Uncapped	Uncapped	-2.9%	2.9%		
-Cap-ex (23-40% incentive rate)	Uncapped	Uncapped	-0.8%	0.8%		
Totex (45-51% incentive rate) ¹	Uncapped	Uncapped	-3.7%	3.7%	-2.0%	2.0%
Sliding scale additional income	Fixed	Fixed	0.0%	0.5%	0.0%	2.7%
IIS ²	Capped	Capped (d/s only)	-0.8%	0.8%	-1.0%	1.0%
Losses	Uncapped	Capped	-3.5%	3.5%	-0.7%	0.7%
Volumes (DP4) / re-opener (DP5)	Uncapped	Capped	-1.2%	1.2%	-0.8%	0.8%
Broad Measure	n/a	Capped	n/a	n/a	-0.3%	0.3%
Guaranteed standards	n/a	Capped	n/a	n/a	-1.00%	0.0%
Tax	Uncapped	Capped	-0.8%	0.8%	-0.4%	0.4%
Cost of debt ³	Uncapped	Uncapped	-0.5%	0.5%	-0.25%	0.25%
Pensions ⁴	Uncapped	Uncapped	~ 0%	~ 0%	-0.15%	0.30%
		Total	-10.5%	11.0%	-6.6%	8.4%

1: DPCR5 range is based on DPCR4 performance under the DPCR5 rules
2: IIS will be uncapped in DPCR5. The upside is assumed to be symmetrically opposite to the 1% collared downside.
3: The range of upside or downside is assumed to be lower than in DPCR4 given that the cost of debt estimate is lower.
4: We assumed that the upside from pensions is £5m upside and £2.5m on the downside (total DPCR5)

1.17. The table above shows the plausible range for equity returns is lower in DPCR5 than in DPCR4 for a number of reasons. First, in considering total expenditure, in DPCR4 the majority of costs overspend related to opex rather than capex. In DPCR5, through the equalisation of incentives, the exposure of DNOs to operational expenditure is therefore significantly less as the vast majority of all costs are now subject to the IQI and thus a lower incentive rate. Second, in DPCR5 the financial impact of performance under the incentive schemes has been limited through the use of caps and collars, which was not the case in DPCR4. In DPCR4, wide ranges of performance were achieved by the DNOs, particularly from the losses incentive. The potential for this has now been significantly reduced through the capping arrangements. Thus, the expected volatility (and hence risk)

of returns from incentives is lower in DPCR5. Finally, in DPCR5, the exposure of DNOs to external factors such as tax and distributed volumes is known in advance through the trigger and re-opener mechanisms whereas in DPCR4 the exposure was unknown. This therefore represents a significant de-risking.

1.18. While we acknowledge that there are some areas where risk may be higher - for example pensions,¹ on balance we believe that our price control package is significantly less risky than DPCR4 and this is consistent with setting a lower cost of capital, all other factors being equal.

Ofgem's decision

Overview

1.19. In coming to a final judgment on the cost of capital we considered:

1. The updated advice of PwC
2. NERA's analysis (which was supported by the DNOs)
3. Reports by CEPA (commissioned by Centrica)
4. Evidence from the capital markets
5. Submissions from the DNOs and other key stakeholders
6. The results of our Return on Regulatory Equity (RoRE) analysis
7. The results of an investors survey

1.20. In reviewing all of the evidence, we determined an appropriate range for the cost of capital and then settled on a point estimate.

Table 1.3 – Ofgem range for the cost of capital

	DPCR5: Ofgem view	
	Low	High
Cost of debt	3.3%	3.7%
Cost of equity	6.3%	7.0%
Gearing	65%	62.50%
WACC (vanilla)	4.3%	4.9%
WACC (post-tax)	3.7%	4.3%

NB: Numbers may not add due to rounding

¹ In theory, the risk has not changed as companies always faced the risk of disallowance given our principle of only allowing economic and efficient pension costs but we accept that in practice, investors may have seen this risk as very low as we have not made a significant disallowance. Under the sharing factors companies will be more directly exposed.

1.21. In the following section we describe our approach and evidence for our spot estimate for each of the elements of the WACC.

Cost of debt

1.22. In the GDPCR, we concluded that a cost of debt of 3.55 per cent was appropriate having considered evidence from long-term trailing averages and short-term market data.

1.23. Since GDPCR Final Proposals were published in December 2007, the spot cost of debt has both risen, and fallen, sharply within a relatively short time period. This movement has also been reflected in the ten year trailing average, which is at a level comparable with that at the time of GDPCR's publication.

1.24. We continue to believe that long-term averages represent the most appropriate basis for setting the cost of debt. We do not think that there is any compelling evidence that the recent turmoil in the financial markets has made this any less appropriate or that there has been a fundamental shift in the cost of debt following the financial crisis. We estimate that the ten year rolling average of the cost of debt for issuers of a similar credit rating to the DNOs is just under 3.3 per cent.

1.25. Some DNOs expressed the view that our cost of debt should reflect their actual embedded cost of debt. Other DNOs rejected this view and said that doing this would significantly weaken or remove the incentives on them to finance their business efficiently. Using actual levels of embedded debt could also, without an assessment of the efficiency of DNO's debt books, benefit shareholders at customers' expense. Some of the embedded debt is over ten years old and over this period many of the DNOs have changed ownership. Investors purchasing a DNO will factor in any difference in the cost of any embedded long term debt and the typical allowed cost of debt set by Ofgem when agreeing a purchase price.

1.26. We therefore consider that our use of trailing averages remains appropriate and provides a strong and ongoing incentive on DNOs to make efficient financing decisions.

1.27. However, we have sense checked our continuing use of this methodology by analysing the typical embedded cost of debt currently serviced by the DNOs. In the past, some DNOs issued very long-term debt at rates which seem unattractive when compared with the prices available today. In contrast, other DNOs have accessed rates considerably below our determination. In setting a WACC for the industry, we think that the use of long-term averages is the most reasonable way of reflecting an efficient long term cost of debt given the long lived nature of the assets the debt is financing. Furthermore, long-term averages offer investors a greater degree of predictability of allowed returns beyond the five years of a price control.

1.28. DNOs have argued that while the observed cost of debt may have fallen in recent months, the costs associated with issuing new debt financing have risen significantly and

should therefore be given special consideration. We do not think it is appropriate to make an explicit allowance for these costs. But there is a spread (approximately 30bps) between our allowed cost of debt and the trailing average which creates headroom to fund any transaction costs.

1.29. We recognise the arguments that it may be more difficult to raise substantial levels of debt finance in current market conditions than previously. We also accept that there is uncertainty about what may happen to the cost of debt when the Bank of England starts to unwind its programme of bond purchases through Quantitative Easing. But we still think it is appropriate for DNOs to manage this risk. A number of energy network companies have successfully placed substantial bond issues of long maturity at rates at or below our assumed cost of debt (these are shown in Table 1.4). DNO's can therefore manage this uncertainty by choosing to issue bonds now and lock in the current, relatively low cost of debt to remove any risk associated with this uncertainty.

Table 1.4 - Recent sterling issuance by utility companies

Issuer	Month in 2009	Amount (£m)	Maturity (yrs)	Nominal Coupon (%)	Real Coupon (%) -
Northern Gas	June	200	10	5.875%	3.1%
ENW Finance	July	200	12	6.125%	3.3%
SSE	September	500	9	5.000%	2.2%
Enel	September	850	15	5.625%	2.8%
Enel	September	1400	31	5.750%	3.0%
Scotia Gas	October	300	9	5.125%	2.4%
EDF Energy	November	350	27	6.000%	3.2%
EDF Energy	November	300	22	6.125%	3.3%
EDF Energy	November	300	7	5.125%	2.4%
			Weighted average (%)	5.6%	2.8%
NB: We deflate the nominal coupons by 2.7% , which is the average of a range of inflation forecasts provided to us by City analysts.					

1.30. In light of all the evidence, we believe that a plausible range for the cost of debt is 3.3 to 3.7 per cent. Our point estimate is in the upper half of this range and reflects the fact that a degree of macroeconomic uncertainty arguably remains. In conclusion, we consider that a cost of debt of 3.6 per cent is appropriate for DPCR5.

Cost of equity

1.31. In assessing the appropriate return on equity, we take a view on the balance of all risks and upside opportunities that DNOs will face under the price control proposals. This provides an appropriate incentive for managers and shareholders to manage these risks

effectively and to make efficient investment decisions. The available returns should sufficiently reward the best performing DNOs that outperform our targets and deliver the agreed outputs at lower prices and/or even better quality of service to customers.

1.32. Traditionally, when setting the cost of equity we have placed considerable weight on historical measures that are based on very long-term data sets. In contrast, in their analysis for the DNOs, NERA proposed a forward-looking measure of the cost of equity derived primarily from a DGM. In their analysis, NERA use data derived from the four listed UK water companies as well as National Grid as they assume their risk profile is most similar to the DNOs. We are not convinced that this approach is appropriate.

1.33. The sample of companies included in this analysis means that there is too great a concentration of specific risk for a forward looking measure. At the time of its publication the water companies were arguably in the middle of the most critical period of their price control review. This was further highlighted on the day of the publication of the Final Determinations when share prices of the water companies moved sharply upwards, against a falling market. We also think the credibility of this approach is questionable given the large range for the cost of equity derived from it (2.4 per cent between highest and lowest) for companies of apparently similar risk profiles.

1.34. Our view that the cost of equity has not increased substantially from its long run average is also shared by other commentators. The Bank of England's Monetary Policy Committee minutes² for their October meeting said that: "according to estimates derived from a dividend discount model, the risk premium for UK equities, which had been extremely elevated in March, had returned to around its average of the past decade." We believe that this statement supports our long-term approach and therefore see no reason to change our methodology to setting the cost of equity.

1.35. Since the publication of GDPCR, a number of factors affecting the spot cost of equity have been particularly volatile. While the risk-free rate - as measured by ILG yields - did spike at the peak of the credit crisis, it has since fallen considerably and is now at levels lower than at GDPCR. The subsequent movement in the trailing average also suggests a lower cost of equity than at GDPCR, all other factors being equal.

1.36. While we acknowledge that there are some issues associated with the use of index-linked gilts, we believe that in the absence of a better alternative they offer the best and most practical way of measuring the risk-free rate (RFR). In our view, other approaches such as a swap-based methodology are fraught with potential problems because of the requirement to have an accurate estimate of expected inflation as well as an appropriate measure of default risk. PwC propose retaining the use of ILGs as the main tool for

² Bank of England Monetary Policy Committee Minutes of the Meeting 7 & 8 October 2009

estimating the RFR and use other methodologies as a cross check. Furthermore, this approach is in line with other regulatory bodies. PwC also support our long term approach and recommend putting greater weight on longer term averages rather than current spot rates.

1.37. The Equity Risk Premium (ERP) measures the additional return required by investors to compensate them for the risk of holding equities over and above the risk-free rate. As we stated in Initial Proposals, we are taking a long-term approach to analysing the ERP for DPCR5. In doing so, we have considered third party evidence e.g. the widely recognised Dimson, Marsh and Staunton dataset and also the views of other regulatory bodies. For example, in the reference for Stansted Airport, the Competition Commission³ suggested a range of 3-5 per cent while Ofwat in their Final Determinations⁴ proposed 5.4 per cent. While we have not disaggregated our cost of equity determination, we have included an additional premium in the ERP to reflect the fact that there is perhaps greater uncertainty in the cost of equity for DPCR5 than at GDPCR.

1.38. We have also considered the relative risk of the DPCR5 package with that of DPCR4 and have used the RoRE measure as a tool in this assessment. We think that the potential risk in DPCR5 is considerably lower than DPCR4 as a number of key factors that could affect equity returns have been capped or removed. They include tax, the losses incentive and the volume driver. In addition, RoRE scenario analysis suggests that the equalisation of opex and capex incentives means a much lower range of equity performance is possible for variations in total expenditure in DPCR5 versus the previous price control - again implying a lower risk. While we acknowledge that there are some factors which have arguably increased risk in DPCR5 e.g. higher incentive rate on capex, we believe that, on balance, DPCR5 is less risky than DPCR4 and that this should be reflected in the cost of equity. See Table 1.2.

1.39. In our assessment of the cost of equity we have also estimated a suitable value for equity beta. We have analysed the share price performance of listed utility companies before and after the financial crisis and think there is sufficient evidence to conclude that utilities, especially regulated companies, are less risky than the market and therefore have an equity beta of less than one. This is demonstrated in the charts below (Figures 1.4 and 1.5) which show the performance of the FTSE Utilities index vs. the FTSE 100 before and after the financial crisis. We believe that this clearly demonstrates the defensive nature of utilities.

³ Competition Commission: Stansted Price Control Review, Final Report published 4 November 2008

⁴ Ofwat: Future water and sewerage charges 2010-15: final determinations, 26 November 2009

Figure 1.4 FTSE utilities vs. FTSE100 (re-based) from Jan 2007 to Mar 2009

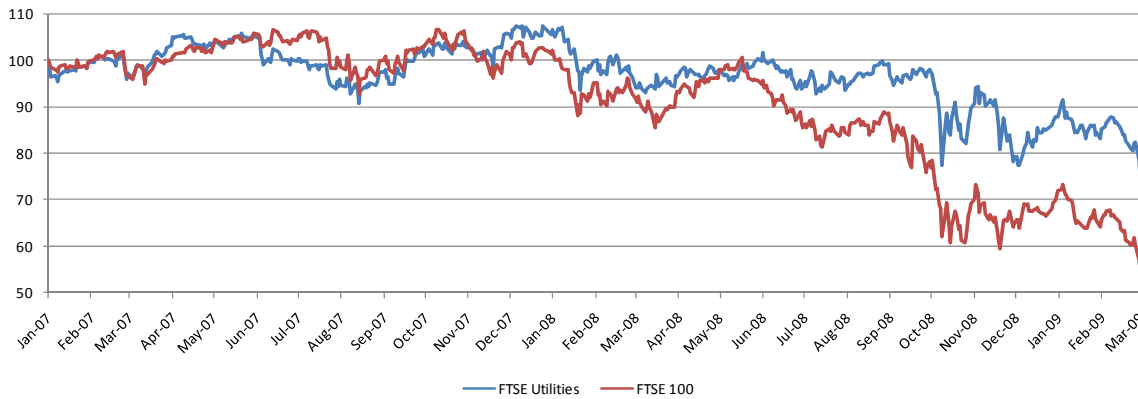
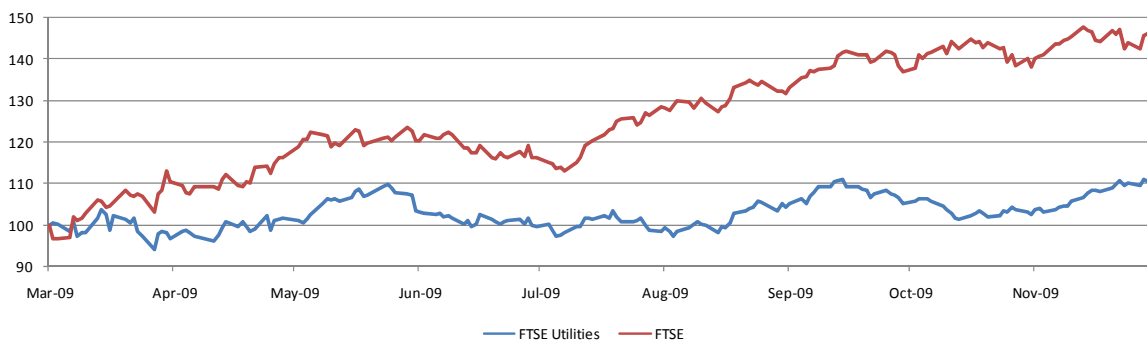


Figure 1.5 FTSE utilities vs. FTSE100 (re-based) from Mar 2009 to Dec 2009



1.40. We have also considered evidence from the asset betas calculated by PwC using the Modigliani-Miller transformation which further reinforces this view (See Table 1.5 below). Our decision is therefore consistent with our view on gearing.

Table 1.5 - Asset betas of comparable companies to DNOs (PwC)

5yr monthly asset betas	Unadjusted asset beta	Blume-adjusted asset beta
National Grid	0.25	0.31
Scottish & Southern Energy	0.41	0.50
Scottish Power	0.26	0.43
United Utilities	0.20	0.26
Severn Trent	0.16	0.24
Penon	0.25	0.33
Kelda	0.25	0.35
AGL Resources (intl comparator)	0.16	0.29
Average	0.24	0.34
Gearing	65%	65%
Equity beta	0.69	0.97

1.41. In light of all the evidence we think that an allowed return on equity of 6.7 per cent appropriately rewards the risks faced by investors in DPCR5. In our analysis we estimated that a plausible range for the cost of equity was between 6.3 and 7 per cent. Hence, our final decision is just above the middle of this range.

Gearing

1.42. In Initial Proposals we said that we thought a notional gearing level of 55 to 65 per cent remains consistent with a credit rating that is comfortably investment grade. PwC also use this assumption.

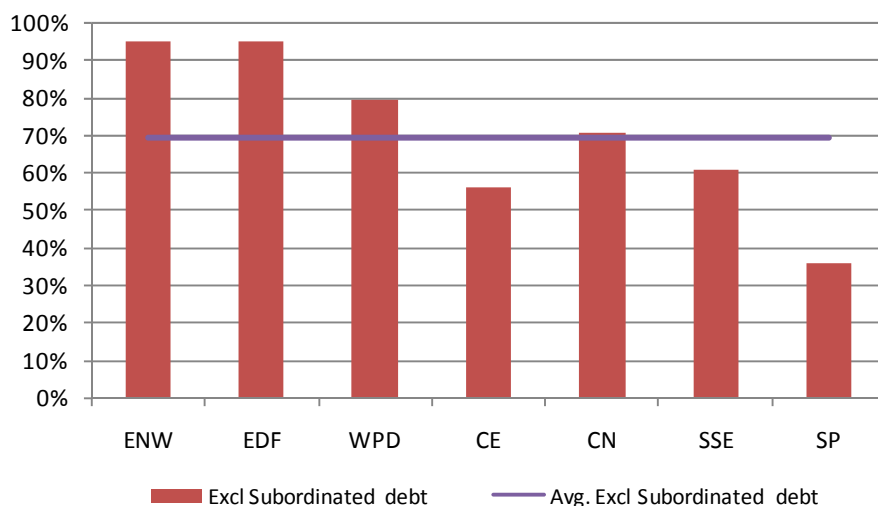
1.43. We have considered evidence published by the various Ratings Agencies in our decision and have cross-checked the result against PwC's asset beta analysis and our cost of equity decision. As shown in table 1.5 a gearing level at the top of our range (and arguably above it) is required to obtain an equity beta approaching one.

1.44. We think that a notional gearing of 65 per cent is appropriate in DPCR5. In some DNO group capital structures, effective gearing levels are considerably higher than our assumption while still retaining an investment grade credit rating.

1.45. Using the group accounts we have estimated the amount of debt supported by cashflows from the regulated company. In the analysis, we assume that non-regulated assets are geared at 30 per cent debt: Enterprise Value (EV), which is broadly comparable with an average FTSE 100 company and companies similar to the non-network part of DNO groups. The results of this analysis are shown in the graph below. We acknowledge that this analysis may be overly simplistic and that it may under or overestimate the "true" gearing levels. However, we have been cautious in our assessment by excluding subordinated debt, a relatively common feature in higher geared capital structures and which can have more debt than equity like features. We believe

that by consistently applying a uniform assumption for all of the groups it provides additional evidence that 65 per cent is a reasonable notional gearing assumption.

Figure 1.6 – Ofgem estimation of gearing (including group debt)



1.46. This evidence of actual gearing structures in DNO groups could suggest that a higher notional gearing level would be appropriate. But we recognise the benefits of stability and predictability in our decisions between reviews and the need to avoid significant shocks to investors by large movements in key elements of the WACC such as notional gearing levels. We think that assuming a 65 per cent notional gearing level in DPCR5 against an assumed notional level of gearing of 57.5 per cent in DPCR4 strikes the right balance between reflecting evidence from the financial markets and capital structures DNOs have put in place (whilst maintaining an investment grade credit rating) and maintaining predictability and stability from review to review. But we note that this decision, which is at the low end of the plausible range, also provides DNOs with further headroom in our decision on the WACC as many groups may choose to maintain financial structures with higher levels of gearing.

1.47. We will consider this issue more fully as part of our RPI-X@20 review and this may conclude that higher levels of notional gearing should be used in future price control reviews or that we should use other mechanisms to protect customers where companies have in place more highly geared structures.

Evidence from RoRE analysis

1.48. In calibrating a holistic price control package, the baseline WACC is only one element of a number of relevant factors that can influence shareholder returns.

Therefore, in making a point estimate for WACC we have used our RoRE analysis as a tool in estimating a plausible range of financial performance under a number of plausible scenarios.

1.49. We have cross-checked our final determination on the cost of capital with the results of the RoRE analysis. At our chosen spot WACC estimate there is a sufficiently strong incentive for the best performing companies to make good equity returns from the price control package. The least efficient companies should not earn the assumed cost of equity if the poor performance is left unaddressed. This is also demonstrated by the analysis. Even under the most extreme scenarios, the least efficient companies can still make positive equity returns but we think this is still appropriate given the level of inefficiency and performance associated with these levels of returns. But this does reinforce our view that the DNOs are less risky than an ‘average’ company and that the equity beta is less than one.

Final WACC determination

1.50. Drawing on all of the above evidence, we think that the baseline allowed return for the 14 electricity distribution licensees should be 4.7 per cent (vanilla, real), equivalent to a post tax return of 4.0 per cent. The following table sets out the assumptions we have used in our financial model.

Table 1.6 – Ofgem’s range and spot decision

	DPCR5: Ofgem view		
	Low	High	Final Proposals
Cost of debt	3.3%	3.7%	3.60%
Cost of equity	6.3%	7.0%	6.7%
Gearing	65%	62.50%	65%
WACC (vanilla)	4.3%	4.9%	4.7%
WACC (post-tax)	3.7%	4.3%	4.0%

NB: Numbers may not add due to rounding

Cost of debt trigger

1.51. In our Initial Proposals, we said that while we were not minded to introduce a mechanism to manage cost of debt fluctuations we would revisit the position in the light of consultation responses and subject to any deterioration in market conditions.

1.52. Following the publication of Initial Proposals, we reviewed the consultation responses which related to the option of a trigger mechanism. The DNOs were almost unanimous in their opposition to a cost of debt trigger saying that it would be too difficult to implement and that companies are best positioned to manage their financing costs. In contrast, Centrica supported the idea of a trigger saying that it would be a reasonable way of managing the uncertainty associated with setting the cost of capital in current

market conditions. We have considered both options and see no reason to change our stance on this issue for DPCR5. However, we will look closely at the arguments and practicalities of introducing such a mechanism as part of the ongoing RPI-X@20 project.

2. Regulatory Asset Value (RAV)

Chapter Summary

The RAV is a financial construct used in our price control calculations to allow the recovery of certain categories of costs, especially expenditure expected to provide long term benefits, over a number of years. The speed of recovery is determined by the regulatory depreciation rate, and a return is earned on the value of the RAV (see Chapter 1). The RAV is indexed to the RPI inflation measure. Additions to the RAV are made according to a set of rules that determine which costs or proportion of costs are included. It is also a key element of our implementation of equalised, rolling incentives for network investment, network operating costs and closely associated indirect costs.

This chapter provides an update on our methodology for determining the timing of cost recovery for the DNOs and our overall approach to calculating RAV additions for DPCR5. It also sets out final closing RAV balances for DPCR4 at 31 March 2010. The methodology is set out in Chapter 1 of the Financial Methodologies document.

Approach to the methodology

2.1. Our approach to developing the new methodology for setting RAV additions and our objectives was set out in Initial Proposals. We have made some updates following responses to Initial Proposals. In Chapter 1 of the Financial Methodologies document we set out the final methodology rules for computing DPCR5 RAV additions and allowed costs of an economic and efficient distribution business.

Update on policy for the timing of recovery of expenditure

2.2. In previous papers, we set out two options for computing RAV additions. We have decided to use the second option set out at Initial Proposals which received broad support from respondents. This option uses five building blocks: (i) network investment, (ii) network operating costs, (iii) indirect costs closely associated with direct work (iv) business support costs and (v) non-operational capital expenditure. Blocks (i), (ii) and (iii) are collectively known as total expenditure or 'totex'⁵. A fixed percentage, 85 per cent of these categories is added to the RAV. Costs in blocks (iv) and (v) are excluded from the RAV.

⁵ Totex - being the aggregate net network investment, net network operating costs and indirect costs, less the cash proceeds of sale of assets and scrap - as defined and explained in Chapter 1 of the Financial Methodologies document.

2.3. Following a review of the draft rules, we have decided to make some minor amendments. We have confirmed that both non-operational capex and business support costs are recovered as fast money⁶. Other refinements are to clarify that all costs in relation to rebranding a company's assets or vehicles following a name change are excluded from RAV. This maintains the policy and treatment we applied in DPCR4. These costs, which arise from corporate activity, should be for the shareholder to bear and are not funded by customers.

2.4. This approach resolves the majority of boundary issues and allows us to apply a 100 per cent incentive rate on business support and non-operational capex costs. We recognise that there may be residual boundary issues, which we will monitor, around the interaction of sole use connections and distribution costs.

2.5. We intend to maintain the same "speed of money" as at Initial Proposals, with 85 per cent of totex being funded through the RAV ("slow money"). The 15 per cent of totex costs that are not added to RAV will be funded in the year of expenditure, (fast cost recovery) through allowed revenues. Business support costs and non-operational assets will also be funded entirely in the year of expenditure. For DPCR5, we have not carried out detailed analysis to put in place an appropriate set of principles to help us determine the "speed of money". We have therefore simply maintained broadly the same "speed of money" as at DPCR4 (including allowances for deficit repair) and cross checked this against RORE analysis and financeability tests to ensure that the package as a whole is appropriate.

2.6. However, we do think it is important to determine a set of principles both for the speed of money and for the closely associated issue of the appropriate rate of depreciation of the RAV. We will deal with these issues as part of our RPI-X@20 review and the conclusions of that review will be applied to the DNOs at the next price control review.

2.7. At Initial Proposals, we had explored with DNOs the option of setting DNO specific RAV addition percentages. The advantage of this would be to tailor the level of capitalisation to each DNOs circumstances. However, we have decided not to use this option for a number of reasons. We have not seen any compelling evidence why the proportion of totex should vary by company. We acknowledge that some DNOs have a smaller proportion of costs in the areas of business support and non-operational capex and therefore will receive a smaller percentage of their overall costs as fast money. However, to the extent that they have a smaller proportion of expenditure in these areas they also have a lesser need for "fast money". We also recognise that the change in approach between DPCR4 and DPCR5 affects some DNOs more than others and we considered whether we should make any specific adjustments for those DNOs who saw a

⁶ Costs recovered in the year of expenditure

reduction in the "speed of money" relative to DPCR4. But we could not see any reasonable, objective basis to make an adjustment for specific companies. We were also satisfied from our analysis that the financeability of these companies is not adversely affected.

Regulatory depreciation and asset lives

2.8. As noted in Initial Proposals, Scottish DNOs are facing a large reduction in their depreciation allowance as their vesting assets⁷ become fully depreciated (the so-called depreciation "cliff-face") at the end of 2009-10. The English & Welsh DNOs faced this cliff-face at previous reviews. This was resolved by changing asset lives for post vesting assets from those assumed at vesting to 20 years with a depreciation catch-up for those assets already added to the RAV since vesting. The catch up is smoothed over 15 years in equal instalments. We confirm that we are extending the same treatment to the Scottish DNOs and continuing with this policy for the English and Welsh DNOs in DPCR5. A depreciation period of 20 years for assets we know will have more than a 40 year life significantly boosts the cash revenues to DNOs in the DPCR5 period. It is one reason we find that in most scenarios there are very few financeability issues. We will consider whether our current approach to depreciation remains appropriate as part of the RPI-X@20 review.

Other RAV policies

Pensions

2.9. We have decided to retain the RAV treatment of pension costs applied in Initial Proposals. Ongoing pension costs will follow the treatment of the underlying employment costs in each of the "fast" and "slow" pots. Where pension costs are associated with business support costs and non-operational capex, they will be recovered by DNOs as 100 per cent "fast" money. Where they are associated with network costs, 85 per cent will be recovered through the RAV and the remainder as "fast" money. Pension deficit repair costs will be funded on a pay-as-you-go basis, albeit with a notional funding period as is set out in Chapter 5.

Related party margins on changes of group structures

2.10. We confirm that we are amending the ad hoc policy applied at DPCR4 of dealing with related party margins on changes of group structures. The revised policy was set

⁷ Vesting assets comprise all assets held by a business at Vesting (i.e. privatisation), with the initial value based on flotation values.

out in Initial Proposals and is incorporated in the DPCR5 RAV methodology in Chapter 1 of the Financial Methodologies document.

Connections

2.11. Customer contributions will be treated in the same way for RAV purposes as the gross costs of providing the connections. Sole use connections, (fully funded by customer contributions) will no longer be taken into account for setting base demand allowed revenues or for RAV purposes. We will still need to monitor closely the allocation of indirect costs between this activity and other activities still covered by price control revenues to ensure that those related to sole use connections are excluded.

Regulatory asset value to 31 March 2010

2.12. The RAV values published below in table 2.1 are those we are using for the opening value of the RAV in arriving at DPCR5 revenue allowances. They have been prepared in accordance with Appendix 1 to the DPCR4 Final Proposals and the guidance in the annual Price Control Cost Reporting Rules - Instructions and Guidance prepared and amended in accordance with standard licence conditions 48 and 49. They are based on actual costs to 31 March 2009 and DNOs' forecasts for the final year to 31 March 2010.

Table 2.1 - Closing RAV values at 31 March 2010

£m 2007-08	Opening RAV at 1 April 2005	Additions	Depreciation	Closing RAV 31 March 2010	Under-grounding & other adjustment	Opening RAV 1 April 2010
CN West	1,124.4	740.1	(486.1)	1,378.4	1.6	1,380.0
CN East	1,111.2	712.6	(486.6)	1,337.1	0.9	1,338.0
ENW	1,078.7	590.1	(461.4)	1,207.4	4.5	1,211.9
CE NEDL	694.9	429.3	(300.3)	824.0	2.8	826.8
CE YEDL	941.6	512.5	(398.2)	1,055.9	1.0	1,056.9
WPD S Wales	676.1	289.6	(296.9)	668.8	0.1	668.9
WPD S West	831.5	430.7	(348.3)	913.9	0.4	914.3
EDFE LPN	1,037.2	603.7	(443.5)	1,197.4	5.3	1,202.7
EDFE SPN	719.5	602.8	(318.8)	1,003.5	4.1	1,007.5
EDFE EPN	1,280.0	917.0	(538.8)	1,658.1	1.3	1,659.4
SP Distribution	1,473.9	478.2	(669.0)	1,283.1	0.2	1,283.3
SP Manweb	869.7	582.2	(373.1)	1,078.8	3.1	1,081.9
SSE Hydro	856.3	287.8	(310.4)	833.8	4.1	837.9
SSE Southern	1,574.2	728.9	(653.5)	1,649.6	3.9	1,653.5
Total	14,269.1	7,905.5	(6,084.8)	16,089.8	33.2	16,123.0

2.13. The RAV numbers shown above in Table 2.1 differ from the forecast made in the DPCR4 Final Proposals. There are a number of factors that have caused this as shown in Table 2.2 below.

Table 2.2 - Movements in forecast closing RAV in DPCR4

£m	Final Proposals DPCR4 (2002-03 prices)				Adjustments to DPCR4 forecast (2007-08 prices):			
	2009-10 Forecast closing balance	Adjustments for 2004-05 actuals	Restated closing balance	Inflation to 2007-08 prices	Closing balance (2007-08 prices)	RAV additions	Regulatory Depreciation	2009-10 RAV closing balance
CN West	1,151.6	(7.8)	1,143.8	200.2	1,344.0	35.0	(0.6)	1,378.4
CN East	1,115.6	(2.3)	1,113.3	194.9	1,308.2	24.8	4.1	1,337.1
ENW	1,080.9	(1.9)	1,078.9	188.9	1,267.8	(67.1)	6.8	1,207.4
CE NEDL	699.9	(5.2)	694.7	121.6	816.3	4.7	2.9	824.0
CE YEDL	906.1	(3.3)	902.8	158.0	1,060.9	(8.6)	3.6	1,055.9
WPD S Wales	569.1	1.8	570.9	99.9	670.8	(2.7)	0.6	668.8
WPD S West	762.1	12.0	774.1	135.5	909.6	7.2	(2.9)	913.9
EDFE LPN	1,075.4	(26.5)	1,048.9	183.6	1,232.5	(51.4)	16.3	1,197.4
EDFE SPN	936.3	(29.1)	907.2	158.8	1,066.0	(87.3)	24.8	1,003.5
EDFE EPN	1,456.3	(49.1)	1,407.2	246.3	1,653.5	(27.2)	31.9	1,658.1
SP Distribution	1,092.8	20.9	1,113.7	195.0	1,308.7	(24.5)	(1.0)	1,283.1
SP Manweb	911.2	4.7	915.9	160.3	1,076.2	6.1	(3.5)	1,078.8
SSE Hydro	708.5	0.9	709.4	124.2	833.5	(2.6)	2.8	833.8
SSE Southern	1,483.5	(10.2)	1,473.3	257.9	1,731.2	(104.7)	23.1	1,649.6
Total	13,949.3	(95.2)	13,854.0	2,425.2	16,279.2	(298.3)	108.9	16,089.8

Movements in closing RAV from Initial Proposals

2.14. Since Initial Proposals, the closing RAV balances have been revised for a number of reasons. In that document we used the DNOs' February FBPO submissions due to data integrity issues, which have been resolved. The revised balances rely on the latest DNO forecasts for 2009-10 and the 2008-09 annual price control cost reporting submissions, which will not be subject to our usual detailed review until 2010. In particular, DNOs have revised their forecasts for 2009-10, in most cases reducing them. In addition, there have been minor amendments arising from changes to the allowed proportion of pension deficits following a review of structural changes to some schemes (see Chapter 5).

Table 2.3 - Movements in RAV from Initial Proposals

Em 2007-08	Closing RAV 31 March 2010 per Initial Proposals	Change in additions	Change in Depreciation	Closing RAV 31 March 2010 Final Proposals	Under-grounding & other adjustment	Opening RAV 1 April 2010
CN West	1,358.7	20.8	(1.1)	1,378.4	1.6	1,380.0
CN East	1,308.0	30.6	(1.5)	1,337.1	0.9	1,338.0
ENW	1,227.2	(20.6)	0.8	1,207.4	4.5	1,211.9
CE NEDL	830.6	(6.8)	0.1	824.0	2.8	826.8
CE YEDL	1,061.5	(5.8)	0.2	1,055.9	1.0	1,056.9
WPD S Wales	671.2	(2.7)	0.3	668.8	0.1	668.9
WPD S West	914.1	(0.3)	0.2	913.9	0.4	914.3
EDFE LPN	1,215.3	(18.6)	0.7	1,197.4	5.3	1,202.7
EDFE SPN	1,001.7	2.2	(0.4)	1,003.5	4.1	1,007.5
EDFE EPN	1,675.3	(17.6)	0.5	1,658.1	1.3	1,659.4
SP Distribution	1,321.5	(38.5)	0.1	1,283.1	0.2	1,283.3
SP Manweb	1,123.6	(44.9)	0.1	1,078.8	3.1	1,081.9
SSE Hydro	847.5	(14.0)	0.2	833.8	4.1	837.9
SSE Southern	1,673.7	(25.0)	0.9	1,649.6	3.9	1,653.5
Total	16,230.0	(141.2)	1.0	16,089.8	33.2	16,123.0

RAV calculation 2008-09 and 2009-10

2.15. We have used DNOs' estimates of 2008-09 and 2009-10 expenditure. The former provided by the companies as part of the annual price control cost reporting returns which have yet to be reviewed in detail. The latter provided by the companies in August 2009 based on revisions to their previous forecasts, on the understanding that these were the best estimates available.

2.16. In the event that actual 2008-09 and 2009-10 RAV additions turn out to be materially different to the estimates, we would not expect to alter revenue in the period 2010-15. Unless the difference is due to genuine efficiencies that could reasonably have

been foreseen at the time the forecast was provided, Ofgem will claw back the benefits of any under-spend in 2008-09 and 2009-10 relative to the estimate used in these proposals at the next review and alter the revenue in the next price control.

Forecast RAV movements in DPCR5

2.17. The forecast movements in RAV over DPCR5, based on our cost assessment work (see the Final Proposals Allowed revenue - Cost assessment document for details), are set out in Chapter 6 and have been computed in accordance with the methodology statement in Chapter 1 of the Financial Methodologies document.

3. Excluded Services

Chapter Summary

This chapter sets out Ofgem's decision on the treatment of excluded services in DPCR5. It covers the scope of excluded services categories, the basis on which DNOs will be able to levy charges and the interaction of excluded services with the main price control provisions.

3.1. We have decided on a number of changes to the price control treatment of “excluded services” - those distribution business services which are excluded from the main price control revenue allowances and charge restriction conditions. We have also set out our approach for ensuring that:

- the costs associated with excluded services (including indirect costs, pension costs and any tax liabilities) are covered by charges raised against the party requiring the service,
- costs covered by excluded services charges are not factored into the main (use of system) revenue allowances and thereby are not double counted,
- the basis for different categories of excluded services charges is made clear - i.e. whether it is to be on a cost recovery only basis or to include a reasonable margin of profit, and
- any adjustments applied where out turn costs or revenues differ from forecast levels (effected through an adjustment to the DNO's RAV) are fair to consumers and DNOs.

3.2. Our aim is to ensure that customers for these services pay a fair charge and that DNOs are incentivised to provide services in an efficient way by being allowed to recover their costs and, in appropriate cases, a reasonable margin of profit.

Services which will not be excluded services in DPCR5

3.3. We have decided that several categories of services should no longer be excluded services in DPCR5:

- Distribution of units to EHV premises connected (or materially altered) after the start of the price control period,
- Provision of charging statements, and
- Reactive energy transportation.

Excluded services in DPCR5

3.4. We have determined that the following categories of services should be excluded services in DPCR5:

Connection services (ES1)

3.5. The service of installing and maintaining electrical plant and equipment where this is required for a new or modified connection to the DNO's network and where the works are not funded by use of system income but instead by charges levied on the connection applicant. The plant and equipment installed may be dedicated to the applicant's connection (sole use) or may relate to a proportion of any upgrades 'up-steam' on the network which serve other customers as well⁸.

3.6. Connection charges (which account for about 70 per cent of all excluded services charges) have been subject to a particular reporting treatment in DPCR4 which indirectly controls profit margins. In DPCR5, DNOs will be allowed to earn a profit margin on some connection charges where they can show that they compete with other providers. Further details are given in Chapter 12 of the Incentives and Obligations document.

Diversions works under an obligation (ES2) & works required by any alteration of premises (ES3)

3.7. The service of relocating any electrical plant or equipment where the requirement has arisen under a statutory obligation (ES2) or to accommodate any alteration of premises (ES3). These services are sometimes referred to generically as 'non-trading rechargeables'.

Top-up, standby and enhanced system security (ES4)

3.8. The service of facilitating or delivering top-up or standby supplies of electricity or providing a higher degree of supply security than would otherwise be the case.

Basis of charging for excluded services under categories ES1 to ES4

3.9. Excluded services under categories ES1 to ES4 are characterised by a broad assumption that the costs (and charges) arise when the customer requiring the service places his or her order. They mainly involve the provision of new infrastructure or

⁸ Generally limited to the part of the network one voltage level above the voltage required by the connection applicant at his premises

modification of existing infrastructure to meet the customer's requirements. The DNO's capex programme should have catered for underlying infrastructure development and the costs driven by the provision of these services should largely be incremental. This means that there is only a limited risk that a DNO could profit by diverting resources which have separately been funded by use of system income. Consequently we do not consider it would be appropriate to make any RAV adjustment in respect of outturn levels of activity for these services. The corollary of this treatment is that the charges levied by DNOs for these services should be set on a cost recovery basis. Since Initial Proposals and after considering feedback we have decided that top-up, standby and enhanced system security (ES4) should be treated in this way.

Revenue protection services (ES5)

3.10. This category includes any service provided at the request of a third party relating to the prevention of meter interference or other forms of theft of electricity. The services must be over and above any duties the DNO has under licence conditions or the DCUSA⁹ which are funded by use of system revenues.

3.11. We have decided that DNOs should be allowed to set charges at a level which allows them to recover their reasonable costs in providing this service together with a reasonable margin of profit. To incentivise DNOs to offer this service whenever it is requested by a third party we have decided that no ex post RAV adjustment should apply.

Metering services (ES6)

3.12. Since 1 April 2007 the market for the provision of new electricity meters and for the servicing of meters has been considered to be competitive with a number of new market entrants and in some cases affiliates of DNOs providing metering services for the group outside the regulated network company. DNOs are still subject to obligations and separate price cap controls in respect of metering equipment installed on or before 31 March 2007 (legacy metering equipment) but all other meter provision and servicing by DNOs is categorised as an excluded service.

3.13. In Initial Proposals we suggested that metering excluded services by DNOs should be subject to a stipulation as to the reasonableness of profit margins and to an ex post RAV adjustment in respect of the difference between forecast and outturn activity levels. However, having listened to representations regarding increased levels of competition in the electricity metering market we have now decided that no such stipulation/adjustment should apply. In reaching that view, we have taken account of the role that DNOs and energy groups expect to play in any smart metering roll out programme. We expect that

⁹ Distribution Connection and Use of System Agreement

the price cap arrangements for legacy metering equipment will remain in place pending any review in the context of developments in smart metering.

Miscellaneous excluded services (ES7)

3.14. This category covers any other service requested by a third party which meets the criteria for an excluded service being:

- an activity of the distribution business (and so not de minimis business), and
- a service not remunerated through use of system charges (or other specified types of charge)

3.15. We have decided that DNOs should be allowed to set charges at a level which allows them to recover their reasonable costs in providing this service together with a reasonable margin of profit. We have also decided that there should be an ex post RAV adjustment in respect of the difference between forecast and out-turn activity levels for this category of excluded service. In fact this is the only category for which we have decided that there should be such an adjustment in DPCR5.

Excluded services adjustments in the DPCR5 financial model

3.16. In order to ensure that costs covered by excluded services charges are not double counted, where necessary we have made an adjustment to DNO's price control allowed revenues. This adjustment shown as a net figure labelled "*Excluded services revenue to be deducted from base revenue*" corrects for instances where excluded services costs have been included in (or incorrectly deducted from) DNO totex figures. The constituent adjustments have been notified to DNOs.

Licence condition covering excluded services

3.17. The drafting of the licence special condition relating to excluded services (CRC 16) will reflect the decisions we have set out in the previous paragraphs. We also intend to provide more detailed guidance on the reporting and treatment of excluded services in the Cost and Revenue Reporting RIGs document.

4. Taxation

Chapter Summary

The DNOs are limited companies and are obliged to pay corporation tax on their profits. We have developed a methodology for calculating a reasonable allowance for DNOs' corporation tax costs.

This chapter sets out our approach to taxation and the tax trigger mechanism. It covers the methodology for modelling tax and the introduction of a tax trigger mechanism. The methodologies are set out in Chapters 11 and 9 respectively of the Financial Methodologies document.

Update on methodology

4.1. We set out our policy and tax methodology and updated the methodology statement at Appendix 3 of our Initial Proposals document. This confirmed our approach for setting ex ante allowances for tax based on a common view of how DNOs' expenditure qualified for tax relief. We have carefully considered responses to that document and concluded that the methodology is robust. For Final Proposals we have decided to maintain the methodology as published in Initial Proposals – see Chapter 11 of the Financial Methodologies document.

4.2. In the course of our post Initial Proposals review DNOs have provided further clarification arising from amended FPBQ submissions. As a consequence, we have made minor revisions to the cost allocation to capital allowance pools. The final allocations are shown in Chapter 11 of the Financial Methodologies document.

Appropriate opening capital allowance pools

4.3. In modelling the tax treatment of DNOs' costs our primary objective is to incentivise DNOs to manage efficiently their tax liabilities. Subject to the tax trigger, they will retain the risk and rewards of doing so. A DNO's closing balance on each of their capital allowance pools has been derived from their submitted corporation tax returns to HMRC and projections for the remainder of the DPCR5 period from their FBQs. It is this position, and subsequent allowed revenues and expenditure, that determines the tax burden that customers should fund and not one based on projections at a previous price control.

4.4. At Initial Proposals, we said that we do not specifically intend to take account of the 2009 budget announcement that there will be a one-year increase in first year allowances (from 20 per cent to 40 per cent) for qualifying assets purchased in 2009-10 as this falls outside of the DPCR5 period. We have reviewed this position and now have allowed for this adjustment and used revised forecasts provided by DNOs of their closing written down values. The effect is to reduce the balances in their general capital allowance (CA)

pools. In addition, we have made minor amendments to the opening capital allowances to reflect updated information provided by the DNOs.

4.5. Some DNOs have suggested that using the forecast closing tax pools at the end of DPCR4 is detrimental to them. Their view is that customers will benefit twice where the modelled tax allowances and actual closing CA pools are materially different. Such differences arise as the DPCR4 methodology did not in all instances follow the statutory treatment of allowing expenditure as deductible for tax but instead followed our own modelling methodology.

4.6. Since Initial Proposals, we have reviewed these arguments, revisited the DPCR4 documents and held further discussions with DNOs. We remain of the view that there is no compelling case for changing our position. There was clearly no statement in the DPCR4 documents that the tax estimates would be adjusted for actual tax allowances. On the contrary, it was made clear that they would not. The DPCR4 tax methodology was applicable specifically to that review and it was not intended to fetter how subsequent controls were determined. We are not seeking to claw back the windfall gains from the reduction in corporation tax rates and the change to the capital allowance rules both effective from 1 April 2008. Any one off adjustment as suggested by some DNOs would amount to a re-opener and would in effect make some aspects of the tax calculation a pass-through which was not our intention at DPCR4.

Tax claw back for excess gearing

4.7. Consistent with our policy in the last three network price controls we will apply an ex post adjustment to claw back from DNOs the tax benefit they obtain from gearing above our notional gearing level.

4.8. The clawback will operate, when in any year, (i) actual gearing exceeds notional gearing¹⁰ and (ii) interest costs exceed those modelled at the relevant price control. In the case where both of these conditions are satisfied, we will clawback the tax benefit which results from the difference between actual and modelled interest costs in that year. The specific methodology is set out in our open letter of 31 July 2009.

4.9. The adjustments in respect of DPCR4, which are included in the DPCR5 revenue allowances at their present value, have been updated from Initial Proposals. This now affects four DNOs and the final amounts are shown in Table 4.1 below.

¹⁰ Notional gearing was set at 57.5 per cent in DPCR4 and 65 per cent in DPCR5

Table 4.1 - Tax clawback adjustments

	2005-06	2006-07	2007-08	2008-09	2009-10
<i>Corp Tax rate</i>	30%	30%	30%	28%	28%
	£m	£m	£m	£m	£m
ENW	-	-	-	-	2.3
WPD S Wales	-	-	1.7	1.9	1.8
EDFE SPN	0.7	-	-	-	-
EDFE EPN	2.1	-	-	-	-

Tax trigger

4.10. We have carefully considered the responses to Initial Proposals and decided to introduce a tax trigger mechanism, which is set out in Chapter 9 of the Financial Methodologies document. In response to arguments made by the DNOs, we have reviewed its scope and have extended it to include changes in, or clarifications to:

- Her Majesty's Revenue and Customs (HMRC) interpretation of legislation,
- new precedents set under case law, and
- any changes in accounting standards that have a direct knock-on effect on the quantum or timing of taxation.

4.11. The latter point recognises that all DNOs will have to prepare their financial statements under International Financial Reporting Standards (IFRS) in 2013. It will allow for the effect of the revised treatment of connection costs and revenues under IFRIC18 *Transfers of Assets from Customers*, to the extent that it changes the tax charge related to the regulated distribution business, for which we set base revenue, e.g. sole use assets and self-financing excluded services that are outside the scope of the price control.

4.12. Any adjustments from the trigger are subject to the trigger event satisfying the key criteria set out in the methodology in Chapter 9 of the Financial Methodologies document and the companies demonstrating that they have made all reasonable representations to mitigate any adverse changes.

4.13. Our intention is not to share the whole burden or benefit arising from changes but to remove the risk DNOs currently face from significant changes. The trigger point is set to broadly reflect a one per cent change in the mainstream rate of corporation tax and to ensure that there is a broadly similar percentage impact on RoRE for each DNO. The trigger point is set at plus or minus 0.33 per cent of a DNO's total base revenue and is assessed on an individual DNO basis. The adjustment will be the excess over the trigger point.

4.14. Adjustments to revenues arising from these changes will, in the case of those arising from changes in the relevant legislation (whether introduced in an Act of Parliament (including Finance Acts), Statutory Instrument or other legislative instrument) be made in the price control period, where possible.

4.15. Adjustments arising from changes in or clarifications to HMRC interpretation of legislation, or new precedents set under case law, or any changes in accounting standards that have a knock-on effect on the quantum or timing of taxation will be dealt with on a case by case basis. DNOs may apply for these items to be adjusted in the period. They will need to:

- demonstrate that the effect of the changes are quantifiable, and
- provide evidence that the treatment has been agreed by HMRC or, in the case of the items above, their appropriate auditor.

4.16. Adjustments will be made within the price control if the effect can be assessed and if not in subsequent controls on a net present value (NPV) neutral basis.

5. Pension costs

Chapter Summary

In 2003 we established a set of pension principles to provide a consistent and common framework across all the network businesses that we regulate. In August 2008 we initiated a review of the operation of these principles and in October 2009 published our minded to position for consultation. This chapter set out our decisions from this consultation process focussing particularly on how they apply to the DNOs.

We also include an update on our approach to the scaling back of pension projections, to our assessment of the regulatory fraction and an update on the true-up adjustment for over and under-funding of pension costs under the DPCR4 settlement. The methodology is set out in Chapter 10 of the Financial Methodologies document.

Process

5.1. We have conducted an extensive, thorough and open consultation process on pension issues in parallel with DPCR5. We have reached our final decision after careful consideration of our duties, the role of Trustees and the role of the Pensions Regulator (TPR). We have also carefully considered all of the responses to our three consultation documents and three seminars. We have taken the necessary steps to ensure that both the Ofgem team and the Authority have had sufficient time to consider responses to the last round of consultation ahead of arriving at a final decision.

5.2. We think that our final proposals, set out below, strike a balance between the needs of companies, employees and (our primary duty to) present and future consumers. We have made some adjustments to our minded to position, having been persuaded by a number of the arguments and evidence put forward by respondents to our last consultation. Since publishing our last consultation we have been in discussion with TPR on the interaction of the regulatory frameworks for gas and electricity markets and for work-based pensions. TPR recognises that the treatment of pension costs, including pension deficits, in regulatory pricing decisions is a matter for the economic regulators. It notes the wide range of approaches by Ofgem and other economic regulators to this issue. TPR is clear however that the approach of trustees to setting funding targets and deficit recovery plans, including cash demands on the employer, is independent of the decisions taken by the economic regulators on pricing. Trustees need to form their own view on the strength of the employer covenant and the affordability of deficit recovery payments. TPR intends to communicate shortly with the trustees of schemes with employers subject to economic regulation.

Decisions

5.3. Our decisions are set out below. These primarily relate to the electricity DNOs that are subject to the current price control review. We will publish a short document in 2010

setting out the decisions as they relate to other network companies. We have summarised our decisions below:

Deficit funding

- To allow the DNOs to recover over time from customers all pension deficits (related to the distribution business and subject to our economic and efficient test) as accrued immediately prior to the next price control period (1 April 2010 in the case of DNOs),
- to apply a 15 year notional funding period across all companies,
- to undertake a full efficiency review of any specific DNO pension schemes where an assessment made by the Government Actuary's Department (GAD) at the end of the regulatory period suggests this is required, and
- for DPCR5, to set allowed revenues based on valuations as of 30 September 2009 using values provided by the DNOs supported by actuarial reports with an adjustment for the actual March 2010 values in DPCR6.

Ongoing pension costs

- To use benchmarking to set ex ante allowances for future reviews, but not in DPCR5,
- for DPCR5, to provide the DNOs revenue allowances to recover the full value of their ongoing pension cost projections. In recognition of the limited control DNOs have over just less than 50 per cent of their staff who are protected persons¹¹ under relevant legislation, the DNOs will carry only 20 per cent of any extra costs they incur above the upfront allowance.
- to provide an incentive for DNOs to control their ongoing costs, the DNOs will be allowed to keep 50 per cent of any underspend in the DPR5 period.

Application issues

- To adopt all of the application principles as set out in the third pension consultation with further clarification on the treatment of bulk transfers and on assessing the regulatory fraction for pipes or wires only businesses.

¹¹ As defined in the Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 in relation to the Electricity Supply Pension Scheme and in the Electricity (Amendment of Scottish Pension Schemes) Regulations 1990.

5.4. We have set out in greater detail below why we have reached these decisions. The relevant methodologies are set out in Chapter 10 of the Financial Methodologies document.

Reasons for reaching our decisions

5.5. Our proposals do not seek to interfere with or override the role of pension trustees or TPR. They do not seek to undermine pension benefits in the sector. Our Final Proposals aim to strike a fair balance between the interests of customers, employees and shareholders. They will expose customers to affordable payments to the pension schemes and provide incentives, where appropriate, on the network companies, to manage their pension costs where they can.

5.6. We confirm our commitment to allow the network companies to recover from customers all pension deficits (relating to the distribution element and subject to our existing economic and efficient test) as accrued immediately prior to the next price control period (1 April 2010 in the case of the electricity distributors). To the best of our knowledge, no other utility regulator has made a similar commitment. Ofwat, for example, has only allowed the water companies to recover 50 per cent of their pension deficit costs from customers in its PR09 final determination.

5.7. We have decided to apply a 15 year notional deficit repair period. The impact on business and domestic consumers in DPCR5 of moving to a shorter period would be substantial. Most DNOs considered that 10 years should be the maximum period. However, using a 10 year notional repair period would increase costs to consumers by £430m over the next five years relative to a 15 year notional period. Spreading the funding of repair payments over 15 years lowers the burden on existing customers. It also allows more time for the uncertainty to reduce about whether the deficits will diminish as the economy recovers. This will reduce the risk that consumers fund the deficits at a faster rate than is necessary during the deepest recession of the last seventy years.

5.8. We have made it very clear that if a company and the scheme's trustees decide that the deficit should be paid off over a shorter period than our assumed notional funding period of 15 years, then the company will be kept revenue neutral on a net present value basis over the 15 year period (i.e. the company will be paid back the cost of financing the gap between our notional 15 year funding period and the actual period of deficit payments agreed with trustees).

5.9. Our Final Proposals for DPCR5 relating to deficit repair periods do not adversely impact on the returns within the network companies. Nor do they have an adverse impact on the accrued benefits to pensioners within the industry. They are simply aimed at making sure that customers pay for this liability in an affordable way.

5.10. We accept that 15 years is at the high end of current arrangements (at the 95 per cent percentile point). In our view, it is entirely appropriate that Ofgem's regulated network businesses should be at the high end of recovery periods (we used 10 years at GDPCR) because of the relatively low risk of DNOs' businesses compared with other companies and the strength of the consumer and regulatory covenant. In unregulated businesses, trustees would understandably want to see as short a repair period wherever practical and affordable. However, for price-controlled network businesses there is not the same risk.

5.11. We consider that in times of significant movements in financial markets and uncertain economic conditions, that the latest valuation provides the most appropriate estimate of the level of deficit. This is reinforced by the fact that 11 DNOs have a full triennial valuation due at 31 March 2010 and three are currently under review. We have concluded that we should apply a consistent valuation date across all DNOs and have used the September valuations provided to us by the DNOs, even where some companies have had a full triennial valuation at 31 March 2009, since there have been material changes in estimated deficits subsequent to those valuations.

5.12. We have carefully considered the responses made to our latest consultation¹², in particular:

- Representations that the PPF7800 index¹³ is not appropriate and that, if we are to have a trigger, we should employ the services of the GAD for this review.
- Arguments that the companies' ability to manage on-going pension costs is severely limited by the protected persons legislation put in place at privatisation, and that we should not therefore ask the companies to fund 50 per cent of the difference between the allowance for on-going costs and the outturn costs.

5.13. We therefore propose a change in approach. We will keep the concept of a trigger for a full efficiency review but replace the PPF7800 index as a trigger with a review by the GAD. We have adjusted our sharing factors for any under- or over-spend against the

¹² <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=88&refer=Networks>

¹³ The PPF7800 index is a monthly summary produced by the Pension Protection Fund which shows the latest estimated funding position, on a Pension Act 2004 section 179 basis, for the defined benefit schemes in its eligible universe.

allowance made for ongoing costs to reflect the concerns set out above regarding the protected persons legislation.

5.14. One respondent argued that DNOs can take action to reduce pension costs of protected persons. We have reviewed the evidence submitted by DNOs in response and the protected person legislation directly. We have concluded that the protected persons legislation provides limited scope to amend benefits already accrued and payable now or in the future to a member or beneficiary, or to adversely amend either future pension rights of protected persons or their contributions. It is only possible to change benefits or increase contributions of protected members in some circumstances if a two-thirds majority of scheme members consent.

DPCR5 methodology

5.15. The methodologies described below for DPCR5 are set out in detail in Chapter 10 of the Financial Methodologies document.

Normal ongoing cost allowances

5.16. We have set allowances for normal ongoing Defined Benefit (DB) and Defined Contribution (DC) pension costs based on the DNOs' own forecast submissions. These have been adjusted to eliminate costs not related to the core distribution activity funded by consumers, e.g. self-financing excluded services, de minimis and unregulated activities based on DNOs own allocations and any amounts that they have been unable to reconcile or specify to activities. In Initial Proposals, we also applied a scaling factor to these costs to reflect the reductions made to the DNOs' cost projections. As we have decided to introduce an explicit, upfront incentive (rather than relying on an ex post economic and efficient test) we have decided not to apply any efficiency adjustment to the DNOs' forecasts, other than to Pension Protection Fund (PPF) levies. The table below sets out the final DPCR5 allowances and compares them to the amounts at Initial Proposals.

Table 5.1 - Normal ongoing cost allowances

DPCR5 total normal contributions (incl PPF & Admin) excl Business Support £m 2007-08	Pensions in Business Support Costs	
	IP	FP
CN West	54.3	55.2
CN East	48.8	45.8
ENW	35.7	45.5
CE NEDL	24.1	31.2
CE YEDL	31.9	40.3
WPD S Wales	24.0	31.7
WPD S West	33.9	44.7
EDFE LPN	26.9	30.3
EDFE SPN	29.0	34.0
EDFE EPN	48.9	51.0
SP Dist	62.7	43.1
SP Manweb	61.2	47.1
SSE Hydro	26.0	23.8
SSE Southern	32.5	34.6
Total	539.8	558.2

Sharing factors

5.17. We do not consider that it is appropriate for there to be a full correction for any differences between the actual cash funding compared to the set allowances. This is a pass through and does not incentivise network operators (NWOs) to manage their pension costs effectively.

5.18. At future price controls (excluding DPCR5), allowances for normal on-going pension costs will be determined as set out in principle one of the price control pension principles, using benchmarking. They will also be part of the overall Information Quality Incentive (IQI) package. Thus ongoing pension costs will be subject to the same incentive rates/sharing factor as all other costs within the IQI regime.

Sharing factors for DPCR5

5.19. As explained in the third pension consultation, for DPCR5 we are unable to use benchmarking of total employment costs as we have not undertaken the necessary data analysis. Instead, a specific sharing mechanism will apply. The sharing mechanism is applicable to the normal ongoing contributions of both DNOs' DB and DC schemes (and, where introduced, employer contributions to Personal Pension Accounts) and include pension scheme administration costs. It excludes the PPF levies, which will be subject to

review and, where appropriate, adjustment dependent on the action taken to mitigate these costs.

5.20. In recognition of the very limited control that DNOs have over protected person's costs, we have reduced the proposed incentive rate from the 50 per cent proposed in our October 2009 consultation. The sharing will be asymmetric to reflect this. The DNO's share of downside risk is reduced to 20 per cent and we maintain the upside incentive rate at 50 per cent to provide an incentive for any creative approaches on pensions. The 20 per cent is a weighted average of the forecast employer contributions to DB and DC schemes, applying 10 per cent¹⁴ to the employer contributions of DB schemes and the 50 per cent applied to the employer contributions of the DC schemes. The 20 per cent reflects approximately the balance at the beginning of DPCR5 between DNOs employees in DB schemes and other staff, and reflects the influence management has on underlying pension costs.

Table 5.2 - Analysis of employees to schemes and calculation of weighting of protected persons - average employees over DPCR5

WEIGHTING	Total	DB scheme		DC scheme	Non scheme	Protected	Other	Weighting	DB scheme	DC scheme
		actives		actives	actives	Total DPCR5* Pension costs		Protecte d 10%	Avg pension costs per person	
		Employees	Protected	Other			£m	£m	Other 50%	£k
CN West	2346	1554	56	579	157	112.3	6.4	12.2%	9.0	1.4
CN East	1686	1131	41	182	333	71.3	2.8	11.5%	10.8	1.4
ENW	1674	712	420	484	58	50.6	32.5	25.6%	12.5	2.3
CE NEDL	947	692	86	78	92	23.5	3.0	14.5%	8.7	1.3
CE YEDL	1138	741	49	238	110	31.3	2.3	12.7%	10.7	0.8
WPD SWales	992	495	398	0	99	18.5	14.9	27.8%	8.4	
WPD SWest	1454	600	645	0	209	30.6	32.9	30.7%	8.2	
EDFE LPN - EEPS	602	413	62	0	127	14.7	2.2	15.2%	15.0	
EDFE LPN - ESPS	647	0	647							
EDFE SPN - EEPS	787	612	88	0	87	22.9	3.3	15.0%	10.7	
EDFE SPN - ESPS	633	0	633							
EDFE EPN - EEPS	1174	937	135	0	102	58.4	8.4	15.0%	11.6	
EDFE EPN - ESPS	758	0	758							
SP Dist	1300	620	247	232	200	22.2	9.7	22.2%	8.2	3.3
SP Manweb	1523	777	310	278	157	31.1	13.5	22.1%	7.3	2.9
SSE Hydro	1319	512	103	417	287	15.6	4.4	18.8%	9.9	1.5
SSE Southern	2527	524	151	1055	797	17.7	13.1	27.0%	10.0	1.4
	21507	10320	4830	3543	2814	520.7	149.6	18.9%		

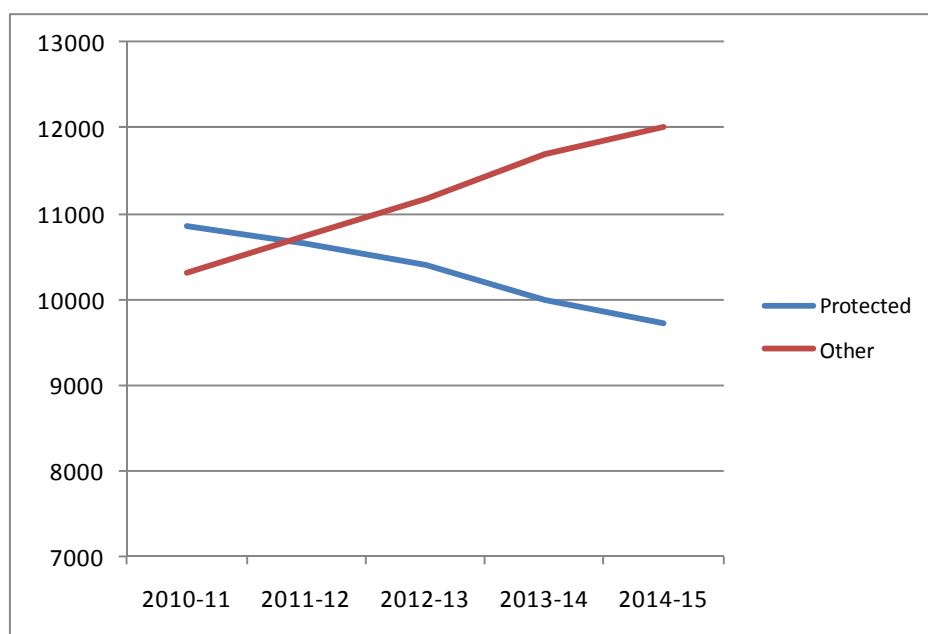
* Pension costs per DNO forecasts

¹⁴ The percentage influence that NWOs had over the ongoing costs of DB schemes according to a trustee respondent.

5.21. The table shows that on average there will be 21,507 employees over the DPCR5 period. Of these, 15,150 (70 per cent) are in DB schemes, 3,543 are in DC schemes (16 per cent) and 2,814 (13 per cent) are not in any scheme. Of those in DB schemes, 10,320 or 68 per cent are protected persons. This represents 48 per cent of total employees over the DPCR5 period.

5.22. Over DPCR5, DNOs have forecast that the number of protected persons in the DB schemes will decline from 51 per cent to 45 per cent. In our view 50 per cent is a reasonable sharing of the costs given the influence that the DNOs have over DC schemes. It also indicates that we think the percentage on the downside will increase in subsequent reviews as the proportion of staff covered by the legislation falls.

Figure 5.1 - Forecast staff in DPCR5 by pension status



5.23. The incentive rate will be applied to the difference between DNOs allowances of ongoing pension costs (including the allowances for pension scheme administration costs and the PPF levies) and actual outturn costs (subject to our review and revision). If the difference in the outturn costs exceed the allowance DNOs will receive an adjustment of 80 per cent of that difference in their revenue allowances at the subsequent control, on a net present value (NPV) neutral basis. Shareholders will therefore bear 20 per cent of the difference. If the difference is an underspend against the allowance, DNOs will retain 50 per cent of it and the other 50 per cent will be adjusted by reducing revenue allowances in DPCR6 on a NPV neutral basis.

5.24. Where at the time of setting the DPCR6 allowances, actual outturn costs are not known for the final year(s) of DPCR5, forecast amounts will be used. These may be subject to our review and revision. In the event that actual costs turn out to be materially different to the estimate, we would expect to alter revenues in DPCR7. If the difference is not due to genuine efficiencies that could not reasonably have been foreseen at the time the forecast was provided, Ofgem will claw back the benefits of any under-spend relative to the estimate used in these proposals at the subsequent review and alter the revenue in that price control.

5.25. The regulatory asset value (RAV) treatment of pension costs is set out in Chapter 2.

Treatment and funding of deficits

5.26. As stated above, in arriving at the DPCR5 revenue allowance for deficit funding we used the latest updated valuations provided by DNOs as at 30 September 2009 (as a proxy for 31 March 2010) and applied the new regulatory fraction, the methodology for which is set out in Chapter 10 of the Financial Methodologies document. Using the latest updated valuations is the preferred option by both a majority of NWO respondents and Ofgem. The deficit funding allowances are calculated by taking the deficit in the September valuation rebased to 2007-08 prices, applying the new regulatory fraction, and spreading the amount over 15 years allowing for a return at 2.6 per cent, which is a similar rate to that which schemes have used to value their liabilities. We consider that this return is reasonable and at the upper end of observed rates, which are between 1 per cent and 2.6 per cent (averaging out at 1.9 per cent). We consider that applying a standard return to all DNOs in setting allowances is consistent with the DPCR4 methodology. We think that our methodology for setting annual deficit funding allowances is reasonable and there will be a true-up process at the end of DPCR5. An example is provided in Chapter 10 of the Financial Methodologies document.

5.27. Deficits in DB schemes as at the end of each current price control (i.e. at 31 March 2010 for electricity distribution) will be funded over a 15 years notional repair period, which will apply across all companies. If a scheme's trustees decide the deficit should be paid off more quickly, then the DNO will be kept revenue neutral on a NPV basis over 15 years, where the costs are efficient.

5.28. The difference in the deficit between the 30 September 2009 valuations (used to set allowances) and that shown by either a full triennial valuation at 31 March 2010, or updated valuations (for those with an earlier valuation date) will be adjusted in revenue allowances at the next price control and be NPV neutral. This difference will be spread over the remaining 10 years of the 15 year notional funding period.

5.29. Table 5.3 sets out the deficit funding allowances for DPCR5 and shows the movement from our 5 October 2009 update letter.

Table 5.3 - Allowance for pension deficit repair funding

DPCR5 Deficit Funding		
£m (2007-08)	05 October	FP
CN West	101	54
CN East	125	76
ENW	45	74
CE NEDL	92	78
CE YEDL	42	37
WPD S Wales	79	56
WPD S West	119	100
EDFE LPN	168	124
EDFE SPN	140	102
EDFE EPN	49	36
SP Distribution	92	38
SP Manweb	104	69
SSE Hydro	174	59
SSE Southern	169	146
TOTAL	1501	1049

Efficiency review and mechanics of true up

5.30. We have decided to retain the concept of a trigger for a full efficiency review of historical pension liability costs ex post, but replacing the PPF 7800 index previously proposed with a review and report by GAD, albeit with different terms of reference to the previous review undertaken as part of the review of our pension principles. Our first, third and fifth principles will be applied at this review and are respectively as follows:

- Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks,
- Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship, and
- In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the price control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis.

5.31. At the end of the control period, or in any case no longer than five years after the initial allowance was set, this review will be used to determine whether a company's pension costs are efficient so that the network company can recover its economic and efficient pension costs irrespective of the allowance set at the start of the control. Where that review indicates that the company's pension costs may be inefficient this will trigger

a more in-depth analysis. Where outturn costs are below forecasts, this will determine whether and how much of any efficiency savings the company should retain. If outturn costs are higher than the allowances, this will determine how much of any overspend the company should fund.

5.32. At the start of each subsequent price control, we will reset deficit funding allowances based on the methodologies set out above. Any under or over recovery of efficient pension costs against the allowance in the previous price control as determined above, will be adjusted in future revenues over the remaining 10 years of the our initial 15 year funding period and be NPV neutral. The companies will only be exposed to funding the timing difference between allowances and their actual deficit repair payments determined between themselves and trustees.

Regulatory fraction and unfunded early retirement deficiency contributions (ERDCs)

5.33. We have reviewed the DNOs' submissions regarding structural changes that occurred in DPCR4 and movements in unfunded ERDCs to determine the allowed proportion or regulatory fraction of each company's pension costs applicable in DPCR5. In DPCR4, these were set out as a percentage of the costs attributable to each DNO irrespective of whether that DNO was part of a larger scheme. In DPCR5, we have calculated the allowed proportion as a percentage of the wider scheme to which each DNO is a sponsoring employer. Where DNOs have more than one DB scheme the regulated portion may be different, so the amount shown is a weighted percentage. The regulatory fraction is then adjusted by the residual value of the unfunded ERDCs at 31 March 2010 as a percentage of the total deficit before applying the regulatory fraction. Table 5.4 shows the regulatory fraction for DPCR5. For the reasons set out in our pension principles these may be subject to revision when the ex post adjustments are assessed.

Table 5.4 - Regulatory fraction

	DR4	Percentage of total scheme			Group schemes
	Basic	DPCR5 base	ERDC adj	Total	
CN West	80%	11.9%	-1.1%	10.9%	Combined 26.3% of total EON scheme
CN East	80%	15.9%	-0.5%	15.4%	
ENW	80%	100.0%	0.0%	100.0%	
CE NEDL	80%	58.7%	-2.5%	56.3%	Combined 83.3% of total NE scheme
CE YEDL	100%	27.4%	-0.4%	27.0%	
WPD S Wales	80%	31.3%	-3.8%	27.5%	Combined 76.3% of total WPD scheme
WPD S West	80%	49.1%	-0.2%	48.8%	
EDFE LPN	80%	36.3%	-0.7%	35.6%	Combined 75.2% of total EDFE schemes
EDFE SPN	80%	30.9%	-1.6%	29.3%	
EDFE EPN	100%	10.3%	0.0%	10.3%	
SP Dist	0%	57.4%	0.0%	57.4%	
SP Manweb	80%	80.0%	-0.3%	79.7%	
SSE Hydro	0%	57.0%	0.0%	57.0%	
SSE Southern	80%	65.9%	-1.3%	64.6%	

Pension scheme administration costs and PPF levies

5.34. We have considered DNO representations and decided to retain our position in Initial Proposals to cap the allowance for the risk-based element of the PPF levy at £0.4m and the fixed element at £0.1m per DNO. Our decision has been determined by comparing the level of forecast levies across DNOs and also considering the Dun & Bradstreet failure scores at 2008-09 as an indicator of steps taken to mitigate the level of such costs.

5.35. We have allowed in full the DNOs' forecasts of pension administration costs on the basis that these appear consistent across companies and that there are no obvious outliers.

Update on clarification of application issues

5.36. We have consulted on a number of application issues, which we and respondents agreed required clarification. The application of these issues informs our assessment of ex ante allowances, where the facts are known and subsequently the ex post adjustments. They relate to the treatment of:

- Pension administration costs,
- Pension Protection Fund levies,
- Stranded surplus,
- Buy-ins and buy-outs,
- Unexpected lump sum deficit payments, and
- Bulk transfers into scheme.

5.37. We have listened carefully to the views expressed in the consultation responses and have decided to confirm our minded to position on these issues below, subject to further clarification to address responses. We have incorporated these decisions into the relevant principles in Appendix 2 to which reference can be made. The key changes from our minded to position are set out below.

Bulk transfers in

5.38. For bulk transfers in, any subsequent deficits will be a risk for shareholders and not consumers. In the principles, we have clarified that this only applies to bulk transfers where individuals or groups of individuals (but not whole or substantially whole, schemes) are transferred as part of a corporate transaction to acquire an activity rather than a licensee. A full merger between two existing DB schemes as a result of a corporate transaction is excluded. Also, as we cannot predict whether the overall treatment will be equitable to all situations, in exceptional circumstances, we retain the option to deal with these on a case-by-case basis.

Regulatory fraction

5.39. In assessing the regulatory fraction, we have accepted respondents' views that the non-regulated component of pension liabilities should logically reduce over time in a closed pension scheme for a predominantly wires or pipes-only business. Thus, the allowed regulated fraction should increase. This is calculated by determining the liabilities attributed to the active scheme members in the regulated business and the movement from the position determined at the previous price control. For DNOs this will, over time, move the fraction to their actual attribution (where supported by the necessary records) from the 80:20 pragmatic split applied at DPCR4. The methodology is set out in Chapter 10 of the Financial Methodologies document.

Monitoring pension costs and pension scheme activity

5.40. We intend to collect from NWOs' data (on an annual basis) on both their actual pension costs and scheme data similar to that collected in the December 2008 DB Scheme questionnaire. We will do this through the annual price control cost reporting process. We will publish such data as is agreed with the NWOs in our annual compliance reports. The licence conditions for DNOs are currently being reviewed in consultation with them, as are the future reporting requirements and structure of future annual reports. Those for Transmission Operators and Gas Distribution Networks will be dealt with either at, or as part of, the annual review of the regulatory reporting rules, and/or at future price control reviews.

Tax treatment of pension costs

5.41. Tax legislation relating to the deductibility of and the treatment of ongoing pension costs and deficits have changed since the last three controls were set. We consider that it is appropriate to set out our position on the tax treatment of deficits in modelling revenues. The basic assumption applied at all price controls is that the distribution and / or transmission business is a standalone taxable entity and all costs should be modelled as incurred in the entity including pension costs.

5.42. We model the cash costs of pensions as deductible in accordance with legislation at 100 per cent, subject to the recently introduced irregular payment rules, which spread the relief over more than one year for significant increases. We will follow tax legislation extant at the relevant price control. Ex post adjustments will be made net at the applicable rate of corporation tax for each year to avoid double-counting the tax effect on the revenues.

Ex post adjustment for over- and under- funding in DPCR4

5.43. The ex post adjustment to DPCR4 is split into three parts. Part one is the 57.7 per cent that has been allowed in the indicative annual RAV calculations. The second is the change to the regulatory depreciation relating to part one. The third is the 42.3 per cent amount expensed. The adjustment methodology is set out in Chapter 10 of the Financial Methodologies document.

5.44. The amount in the RAV will be funded in future years by way of regulatory depreciation and continue to earn a return equal to the allowed WACC for each review. To the extent that regulatory depreciation was foregone in DPCR4, we allow additional revenue in DPCR5, with a net present value adjustment to reflect the delay in revenues. The same approach is taken in respect of the 42.3 per cent expensed. These are both funded in DPCR5 in year one and are calculated net of corporation tax at 30 per cent, being the amount applicable when the DPCR4 allowances were set.

5.45. The amounts have been updated from Initial Proposals following changes to the regulatory fraction for some DNOs where there were structural changes in the scheme during DPCR4 and for amended data from the latest forecast 2009-10 submissions and the 2008-09 actual cost reporting returns. The cash amount has been added to revenues in DPCR5.

Table 5.5 - Cash adjustment in DPCR5 and amount included in closing RAV

£m (2007/08)	Cash	Additions in closing RAV
CN West	9.6	6.5
CN East	6.9	6.8
ENW	17.2	8.0
CE NEDL	(0.6)	(0.3)
CE YEDL	(0.6)	(0.4)
WPD S Wales	(0.7)	1.8
WPD S West	(1.8)	0.6
EDFE LPN	(4.3)	(10.4)
EDFE SPN	(7.7)	(15.0)
EDFE EPN	(0.4)	(1.1)
SP Distribution	0.8	2.4
SP Manweb	15.5	12.6
SSE Hydro	3.6	14.4
SSE Southern	(4.9)	(9.5)
	32.7	16.3

5.46. The table below shows the movement in the adjustment from Initial Proposals.

Table 5.6 - Movement in cash adjustment since Initial Proposals

£m (2007/08)	Initial Proposals	Final Proposals	Change
CN West	6.7	9.6	2.9
CN East	5.2	6.9	1.7
ENW	12.9	17.2	4.3
CE NEDL	0.4	(0.6)	(0.9)
CE YEDL	(0.5)	(0.6)	(0.1)
WPD S Wales	0.8	(0.7)	(1.5)
WPD S West	0.9	(1.8)	(2.7)
EDFE LPN	(7.3)	(4.3)	3.0
EDFE SPN	(10.6)	(7.7)	2.9
EDFE EPN	(0.6)	(0.4)	0.2
SP Distribution	3.2	0.8	(2.4)
SP Manweb	14.4	15.5	1.1
SSE Hydro	4.0	3.6	(0.4)
SSE Southern	(2.4)	(4.9)	(2.5)
	27.1	32.7	5.6

DPCR4 regulatory fractions

5.47. During DPCR4, there were a number of structural changes to some pension schemes including mergers and transfers in and out of groups of members following corporate transactions. In addition, there were several expected and unexpected lump sum payments by DNOs into schemes to fund in part, or in full, deficits. As previously indicated, we have reviewed these transactions and the impact on the regulatory fraction attributable to the regulated distribution business.

5.48. At DPCR4, SP Distribution and SSE Hydro's pension schemes were both in surplus and no regulatory fraction was set. SSE Hydro's latest full actuarial valuation shows a deficit and has forecast a deficit repair payment in 2009-10. We have determined a regulatory fraction in consultation with the DNO for that year. Electricity North West's regulatory fraction was revised to 100 per cent following the restructuring of their scheme when United Utilities sold the company and Electricity North West only retained the distribution members and not any related to unregulated activities. The regulatory fraction for each of Central Networks (CN) East and CN West was revised following a merger of the schemes with those of E.ON UK Group for Powergen and other schemes of the former East Midlands and Midlands Electricity businesses. SSE Southern has been revised following bulk transfers in relation to corporate transactions in unregulated activities during 2007-08.

5.49. The revised regulatory fractions applied to the DPCR4 true-up adjustment of under- / over-funding for each year are set out in the table below:

Table 5.7 - Revised DPCR4 Regulatory Fractions

	DPCR4 Modelled	Actual DPCR4 fractions				
		2005-06	2006-07	2007-08	2008-09	2009-10
CN West	64.0%	64.0%	91.0%	91.0%	91.0%	91.0%
CN East	66.0%	66.0%	91.0%	91.0%	91.0%	91.0%
ENW	66.0%	66.0%	66.0%	66.0%	100.0%	100.0%
CE NEDL	71.0%	71.0%	71.0%	71.0%	71.0%	71.0%
CE YEDL	95.0%	95.0%	95.0%	95.0%	95.0%	95.0%
WPD S Wales	69.0%	69.0%	69.0%	69.0%	69.0%	69.0%
WPD S West	61.0%	61.0%	61.0%	61.0%	61.0%	61.0%
EDFE LPN	75.0%	75.0%	75.0%	75.0%	75.0%	75.0%
EDFE SPN	68.0%	68.0%	68.0%	68.0%	68.0%	68.0%
EDFE EPN	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
SP Dist	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SP Manweb	79.0%	79.0%	79.0%	79.0%	79.0%	79.0%
SSE Hydro	n.a.	n.a.	n.a.	n.a.	n.a.	55.0%
SSE Southern	76.0%	76.0%	76.0%	67.0%	67.0%	67.0%

6. Revenue allowances and financial modelling

Chapter Summary

This chapter brings together the effects of all our policy decisions on how much revenue the DNOs are allowed to recover. We set out our proposals on the form, structure and scope of the price control, explain how we have tested that these represent sufficient revenues for efficient DNOs to finance their businesses and discuss the profiling of revenues. Finally, we set out the total allowed revenues resulting from our Final Proposals.

Form, structure and scope of the price control

Form of the price control

6.1. In DPCR5, we will continue to apply the RPI-X form of price control for the five year period, from 1 April 2010 to 31 March 2015. The RPI index will therefore be used for the indexation of allowed revenues and RAV during this period.

Profiling of revenues

6.2. In our Initial Proposals document we said that we would consider the option of smoothing revenues to produce a consistent X for each company in light of a number of factors. They included:

- The impact of a sharp rise in distribution charges on consumers (and suppliers given fixed price contracts in both the domestic and business retail markets) in the context of an economic downturn,
- The impact of the depreciation cliff-face on the Scottish companies which causes a significant fall in allowed revenue in 2011-12,
- Financeability, and
- The potential for a step-change in allowed revenues in DPCR6, which could be undesirable.

6.3. Having considered the advantages and disadvantages of profiling allowances, we considered a number of options, including:

- matching revenues with costs,
- constant X profiling, and
- back-end weighting of revenues into later years of the price control.

6.4. We think that our primary duty to protect consumers means that the potential impact of a significant rise in charges carries significant weight. We have therefore decided that the allowed revenue increases will be smoothed over the 2010-15 period to achieve a constant percentage increase each year. While we did consider loading the bulk of revenues into the later years of the price control, we did not want to introduce financeability problems or a significant risk of significant price changes between DPCR5 and DPCR6 and so decided against this option.

6.5. While in present value terms, the total revenue will be the same regardless of our decision, we think that a profiled option represents the best option for customers. We have sense checked this decision against our three key financeability ratios. Profiling revenues in this way does not create any financeability concerns.

Structure of the price control

6.6. The proposed structure of the price control comprises:

- DNO base revenue allowances. These allowances are linked to incentive mechanisms that encourage DNOs to:
 - operate, maintain and invest in their networks at an efficient cost,
 - reduce electrical losses and promote energy efficiency,
 - connect distributed generation, and
 - improve the quality of service delivered to consumers, particularly in relation to the number and duration of supply interruptions and customer satisfaction.
- pass-through for certain specified non-controllable costs,
- a requirement to deliver certain agreed network outputs and workforce renewal, for which adequate costs have been allowed,
- the Low Carbon Networks fund for carrying out trials of engineering and commercial solutions to the challenges of distributing electricity in a low carbon society,
- a separate fund for continuing innovation, for undergrounding in Areas of Outstanding Natural Beauty and for addressing the quality of service received by worst served customers on the networks,
- a correction mechanism that adjusts the price control for any previous over or under recovery of revenue, and
- adjustment mechanisms for specific uncertain costs including:
 - changes in tax liabilities (see Chapter 4),
 - pension costs (see Chapter 5),
 - Traffic Management Act (TMA) (see the Cost Assessment document), and
 - general reinforcement (see the Cost Assessment document).

Pass through of non-controllable costs

6.7. Ofgem proposes that the price control will pass-through:

- a proportion of transmission exit charges,
- charges from other licensed distributors, covered by their price controls, for the transportation of units to the network of the DNO concerned (wheeling charges),
- variations in network business rates and Ofgem licence fees from the costs assumed in setting the price control,
- the benefit of any subsidy for areas with high distribution costs.

Over and under recovery of revenues

6.8. We propose that there will be one correction factor for all recovered revenues and that the correct allocation of prices for customers will be ensured via the charging methodology.

Allowances for use of system bad debts suffered by DNOs during DPCR4

6.9. We have assessed the information provided by each DNO on use of system bad debts suffered by them during DPCR4 against the best practice principles set out in our 2005 best practice conclusions document¹⁵ and the specific credit control requirements set out in the DCUSA¹⁶. To achieve this we required each DNO to submit detailed information relating to each defaulting network user.

6.10. Our overall approach continues to be one of balancing the need to facilitate competition in retail energy supply (by facilitating network access for smaller market entrants) and protecting consumers from the costs associated with bad debts passed through to them by network operators when suppliers fail.

6.11. The total amount of bad debts eligible for recovery by DNOs through DPCR5 revenue allowances is £6.4m, relating to the failure of seven electricity suppliers. This figure consists of amounts either written off in the DNO's financial accounts or in respect of which specific provisions have been made. It is net of any recoveries of amounts

¹⁵ Best practice guidelines for gas and electricity network operator credit cover (58/05)

¹⁶ Distribution Connection and Use of System Agreement (Standard Licence Condition 22 refers)

previously allowed, for example where the DNO has received a dividend from an insolvency process. The highest claim by a single DNO was £0.7m and the lowest was £0.1m (to one decimal place).

6.12. DNOs have indicated that they expect that the level of use of system bad debts may be somewhat higher during the DPCR5 period. We have decided that DNOs should continue to 'log up' any future bad debts, keeping sufficient records to allow for future evaluation against best practice criteria. Although we expect any commensurate adjustment to allowed revenue to be applied at the next price control review, we will consider whether it is appropriate to approve/disapprove amounts as part of the annual cost reporting process (subject to later adjustment for any recoveries).

Network Rates

6.13. The companies are faced with substantial increases in business rates on network assets from the start of the next price control period. We have encouraged the companies to take all possible steps to minimise the scale of the increase and have liaised with them throughout the revaluation review. We are satisfied that DNOs have substantially mitigated the increases. Rateable values have now been established and Ofgem proposes that business rates, during DPCR5, on network assets should be treated as a pass through item. The values included for business rates in these proposals are in total 32 per cent lower than those in the Initial Proposals and are set out in the table below – any variations (whether positive or negative) from these values will be passed-through in the price control formula.

Table 6.1 – Business rates in DPCR5

(£m 2007/08)	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total		Change (%)
							Final proposals	Initial proposals	
CE NEDL	13.5	14.0	13.1	12.3	10.8	10.1	60.4	101.1	-40%
CE YEDL	18.2	21.3	21.3	21.3	21.3	21.3	106.7	136.6	-22%
CN East	27.6	30.6	30.6	30.6	30.6	30.6	153.1	217.9	-30%
CN West	20.6	23.1	23.1	23.1	23.1	23.1	115.6	162.1	-29%
EDFE EPN	25.7	31.3	32.6	32.6	32.6	32.6	161.6	192.5	-16%
EDFE LPN	22.6	24.1	22.9	22.9	22.9	22.9	115.6	169.9	-32%
EDFE SPN	7.0	8.5	9.7	11.3	13.8	14.5	57.8	52.3	11%
ENW	17.1	20.6	20.6	20.6	20.6	20.6	103.1	128.1	-19%
SP Distribution	27.5	31.2	31.2	31.2	31.2	31.2	156.0	206.6	-24%
SP Manweb	16.3	15.5	14.7	14.0	12.7	12.4	69.4	122.4	-43%
SSE Hydro	16.0	16.9	16.9	16.9	16.9	16.9	84.7	132.0	-36%
SSE Southern	40.8	39.3	36.8	35.4	35.4	35.4	182.4	336.6	-46%
WPD-South Wales	35.8	13.8	13.8	13.8	13.8	13.8	69.1	135.0	-49%
WPD-South West	34.6	18.5	17.4	16.2	14.3	13.0	79.4	135.0	-41%
Total	323.3	308.8	304.9	302.4	300.2	298.5	1,514.9	2,228.1	-32%

Financial modelling

Overview

6.14. We have calculated the baseline allowances set out below using an Excel spreadsheet financial model. This model uses similar calculations to those used in previous price controls and has been shared with the DNOs during its development. We have had the model audited by an external firm (PKF) to ensure its arithmetic accuracy and that its calculations of allowed revenues are consistent with our financial, regulatory and economic assumptions. We have published a copy of the model, along with explanatory documentation, alongside this document.

Changes in modelling since Initial Proposals

6.15. We have made a number of changes to the financial model to reflect progress since Initial Proposals. A summary of these changes is as follows.

Updates from DNOs

6.16. Information received from DNOs since Initial Proposals has been integrated into the financial model. This information includes:

- updated losses roller data,
- fair value adjustments,
- updated FBPO information, including rates forecasts,
- bad debt values,
- updates from within the DPCR5 project, and
- updated pension data.

Corrections and amendments to the financial model

6.17. The financial model has been improved following feedback from DNOs and other stakeholders. The complete list in 'Change History' in the financial model includes the following items:

- RPI updates,
- correction of linkages, and
- included the July – Dec indexing for DNO revenues, as per the licence conditions

Updates from OFGEM DPCR5 teams

6.18. Policy decisions made during the DPCR5 process have been included in the financial model. These changes included

-
- Removal of IQI additional income from the normal pensions scaling factor,
 - Updated cost forecasts,
 - Improved accuracy of forecast costs and revenues for the Low Carbon Networks fund,
 - Updated RAV forecasts,
 - Amended WACC in light of the decision by the Authority,
 - The inclusion of costs relating to transmission exit charges,
 - Revised funding of pension deficits, and
 - Profiling of allowed revenues.

Financeability

6.19. As set out in our Initial Proposals, we have assessed the financeability of the DNOs based on our notional capital structure against three key credit metrics: Funds From Operations ("FFO")/Interest; Retained Cash Flow ("RCF")/Net Debt; and Net Debt/RAV. The use of these ratios is consistent with previous price controls while the target values of 3x and 9 per cent are respectively the same for the first two. However, in Final Proposals we have changed the value for the Net Debt: RAV ratio to 70 per cent (from 65 per cent). This decision is supported by our analysis which shows that DNOs can support significantly higher levels of debt while still retaining an investment grade credit rating. We have also discussed the issue with the Ratings Agencies.

DNO base revenue allowances

6.20. The following tables show the calculation of the price control final proposal allowances and projected RAV roll forward for 2010-15 for each of the 14 DNOs. The calculation of the movement in the RAV is shown on lines 1 to 6. The opening value of the RAV (line 1) is equal to the closing value of the RAV for 2009-10 as set out in Chapter 2, Table 2.1 above.

6.21. RAV additions - effectively 85 per cent of all network costs, including attributable ongoing pension costs is shown on line 2. This is added to the opening RAV and the allowed level of depreciation (line 3/line 8) is subtracted from it to give a closing asset value (line 4). The closing value in any year then becomes the next year's opening value (with the exception of 2009/10 closing balance, which is subject to a number of adjustments between price controls).

6.22. The present value of the closing RAV in each year is shown in line 5. The present value movement in the RAV is then derived by subtracting the present value of the closing RAV from the opening RAV (line 6). Present value calculations involve discounting values by the vanilla WACC (4.7 per cent).

6.23. The allowed levels of costs, ex ante incentive expectations and ex post adjustments from the previous price control are shown in lines 7 to 19. Fast pot costs (line 7) include 15 per cent of network costs and 100 per cent of business support costs. Pension deficit funding is shown in line 9 and fast pot pension costs (15 per cent of pension costs

attributable to network costs and 100 per cent of those attributable to business support costs) on line 10. Our proposed allowances for corporation tax are set out on line 12. The cash allowance for RAV expenditure in each year is the sum of lines 8 and 11, being the return on the RAV plus the depreciation allowance. This is also equal to the sum of lines 2 and 6. Lines 13-15 are the ex post adjustments for DPCR4 in respect of capital expenditure, losses performance and pensions respectively. Line 19 shows the additional income earned or penalty incurred by the company under the information quality incentive (IQI). Line 17 shows our ex ante estimate of allowances under our innovation and low carbon network incentives. Line 21 is the sum of all items in lines 7-19.

6.24. Line 22 is the estimated non-controllable costs as set out in paragraph 6.7 above. Line 23 is an estimate of excluded services revenue whose scope and treatment for DPCR5 is set out in Chapter 3 of this document. Line 24 is the sum of lines 21 to 23, and is the total price control revenue allowance before applying a constant X profile. Line 25 shows the total price control allowance as profiled.

6.25. Line 27 shows the percentage change in total allowances from the prior year before profiling. Line 28 shows this percentage change once profiling has been applied.

Electricity Distribution Price Control Review
Final Proposals – Allowed Revenues and Financial Issues

7 December 2009

CN West		09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
		£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)									
1	Opening asset value	1,347.2	1,380.0	1,433.4	1,485.2	1,543.0	1,598.6	7,440.2	1,488.0
2	Total RAV additions	144.6	172.5	178.2	188.6	191.5	194.5	925.3	185.1
3	Depreciation	111.8	119.0	126.4	130.9	135.9	140.9	653.1	130.6
4	Closing asset value	1,380.0	1,433.4	1,485.2	1,543.0	1,598.6	1,652.1	7,712.4	1,542.5
5	Present value of closing RAV	1,307.5	1,369.3	1,418.8	1,473.9	1,527.0	1,578.2	7,367.2	1,473.4
6	Allowance for change in RAV		10.9	15.0	11.6	16.3	20.8	74.7	14.9
Allowed costs									
7	Fast Pot	52.2	52.4	53.7	55.9	56.1	56.2	274.4	54.9
8	Depreciation	110.7	119.0	126.4	130.9	135.9	140.9	653.1	130.6
9	Pension deficit	-	10.7	10.7	10.7	10.7	10.7	53.6	10.7
10	Pension costs expensed	8.1	2.8	2.9	2.9	2.8	2.8	14.2	2.8
11	Return	61.2	64.4	66.8	69.3	71.9	74.4	346.8	69.4
12	Tax allowance	31.4	25.7	22.9	22.4	24.3	25.5	120.8	24.2
13	Capex Incentive Scheme	0.7	(0.9)	(3.2)	(2.6)	(1.5)	0.0	(8.1)	(1.6)
14	Losses Incentive Scheme	-	(3.9)	(3.8)	(3.0)	-	-	(10.7)	(2.1)
15	DPCR4 costs	10.4	10.4	0.5	-	-	-	10.9	2.2
16	Innovation Fund Incentive	1.2	1.2	1.3	1.3	1.3	1.4	6.6	-
17	Low Carbon Networks Fund	-	1.4	6.8	7.6	8.5	9.3	33.6	6.7
18	CI/CML, Transmission exit charges	10.9	10.3	10.3	10.9	12.2	19.7	63.4	12.7
19	IOI incentive allowance, QOS adjustment	1.9	3.6	3.6	3.6	3.6	3.6	18.1	3.6
20	2009/10 volume driver	(10.0)	-	-	-	-	-	-	-
21	Total costs	278.6	297.3	298.9	309.9	325.9	344.7	1,576.6	315.3
Price Control Revenue									
22	Pass through costs	25.4	24.2	24.3	24.3	24.3	24.3	121.2	24.2
23	Excluded revenues	(2.8)	2.6	2.6	2.6	2.6	2.6	13.1	2.6
24	Base price control revenue (before profiling)	301.1	324.1	325.7	336.8	352.7	371.6	1,711.0	342.2
25	Base price control revenue (after profiling)	-	314.1	327.7	341.8	356.5	371.9	1,712.0	-
26	Price Control Revenue for 2009-10 as forecast								Avg X
27	Change as %age (Unprofiled)		7.6%	0.5%	3.4%	4.7%	5.3%		4.29%
28	Change as %age (Profiled)		4.3%	4.3%	4.3%	4.3%	4.3%		4.31%

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CN East		09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
		£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)									
1	Opening asset value	1,298.5	1,338.0	1,391.8	1,446.6	1,516.7	1,579.2	7,272.3	1,454.5
2	Total RAV additions	150.5	172.3	180.2	198.8	195.4	194.9	941.6	188.3
3	Depreciation	111.0	118.5	125.4	128.7	133.0	136.5	642.1	128.4
4	Closing asset value	1,338.0	1,391.8	1,446.6	1,516.7	1,579.2	1,637.6	7,571.9	1,514.4
5	Present value of closing RAV	1,267.7	1,329.5	1,381.9	1,448.8	1,508.5	1,564.3	7,233.0	1,446.6
6	Allowance for change in RAV		8.7	10.1	(2.3)	8.4	15.3	40.3	8.1
Allowed costs									
7	Fast Pot	56.0	50.1	51.8	55.6	54.6	53.9	266.0	53.2
8	Depreciation	110.5	118.5	125.4	128.7	133.0	136.5	642.1	128.4
9	Pension deficit	-	15.2	15.2	15.2	15.2	15.2	76.2	15.2
10	Pension costs expensed	6.5	2.4	2.5	2.6	2.5	2.5	12.5	2.5
11	Return	60.4	62.5	65.0	67.8	70.9	73.6	339.8	68.0
12	Tax allowance	31.5	21.8	20.5	19.9	21.0	21.6	104.8	21.0
13	Capex Incentive Scheme	(0.3)	(2.0)	(5.3)	(5.5)	(3.4)	(0.7)	(16.9)	(3.4)
14	Losses Incentive Scheme	-	5.8	4.8	0.5	-	-	11.0	2.2
15	DPCR4 costs	8.7	7.6	0.4	-	-	-	8.0	1.6
16	Innovation Fund Incentive	1.3	1.3	1.3	1.3	1.4	1.4	6.8	-
17	Low Carbon Networks Fund	-	1.4	7.2	8.1	9.0	9.9	35.6	7.1
18	CI/CML, Transmission exit charges	7.0	6.7	7.2	7.9	16.6	21.2	59.6	11.9
19	IOI incentive allowance, QOS adjustment	1.8	3.7	3.7	3.7	3.7	3.7	18.6	3.7
20	2009/10 volume driver	(9.7)	-	-	-	-	-	-	-
21	Total costs	273.8	295.2	299.8	305.9	324.5	338.9	1,564.2	312.8
Price Control Revenue									
22	Pass through costs	33.5	31.7	31.8	31.8	31.8	31.8	159.1	31.8
23	Excluded revenues	(4.1)	3.9	3.9	3.9	3.9	3.9	19.6	3.9
24	Base price control revenue (before profiling)	303.2	330.8	335.5	341.6	360.3	374.6	1,742.9	348.6
25	Base price control revenue (after profiling)	-	317.5	332.6	348.3	364.8	382.0	1,745.2	-
26	Price Control Revenue for 2009-10 as forecast								Avg X
27	Change as %age (Unprofiled)		9.1%	1.4%	1.8%	5.5%	4.0%		4.32%
28	Change as %age (Profiled)		4.7%	4.7%	4.7%	4.7%	4.7%		4.73%

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ENW	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	1,191.0	1,211.9	1,259.0	1,316.0	1,368.0	1,392.1	6,546.9	1,309.4
2 Total RAV additions	124.7	157.1	173.9	175.1	150.9	154.8	811.8	162.4
3 Depreciation	103.8	110.0	116.9	123.1	126.7	129.7	606.4	121.3
4 Closing asset value	1,211.9	1,259.0	1,316.0	1,368.0	1,392.1	1,417.3	6,752.3	1,350.5
5 Present value of closing RAV	1,148.2	1,202.6	1,257.1	1,306.7	1,329.8	1,353.8	6,450.1	1,290.0
6 Allowance for change in RAV		9.5	1.9	9.4	39.0	39.2	99.0	19.8
Allowed costs								
7 Fast Pot	49.2	76.0	73.0	69.2	63.0	64.1	345.4	69.1
8 Depreciation	106.8	110.0	116.9	123.1	126.7	129.7	606.4	121.3
9 Pension deficit	-	14.7	14.7	14.7	14.7	14.7	73.6	14.7
10 Pension costs expensed	8.0	6.8	6.8	6.8	6.8	6.8	34.0	6.8
11 Return	56.6	56.6	58.9	61.4	63.2	64.3	304.4	60.9
12 Tax allowance	29.2	47.0	38.5	36.4	35.6	36.7	194.2	38.8
13 Capex Incentive Scheme	(0.6)	2.6	6.0	3.4	2.3	1.1	15.4	3.1
14 Losses Incentive Scheme	-	(6.8)	(8.0)	(0.6)	-	-	(15.5)	(3.1)
15 DPCR4 costs	10.7	18.1	1.8	-	-	-	19.9	4.0
16 Innovation Fund Incentive	1.2	1.2	1.5	1.4	1.4	1.4	7.0	-
17 Low Carbon Networks Fund	-	1.3	6.5	7.4	8.2	9.0	32.4	6.5
18 CI/CML Transmission exit charges	12.3	12.2	13.7	13.3	13.1	14.3	66.6	13.3
19 IQI incentive allowance, QOS adjustment	2.2	2.2	2.2	2.2	2.2	2.2	11.1	2.2
20 2009/10 volume driver	(8.0)	-	-	-	-	-	-	-
21 Total costs	267.6	341.9	332.5	338.8	337.2	344.4	1,694.8	339.0
Price Control Revenue								
22 Pass through costs	21.6	21.6	21.6	21.6	21.6	21.6	108.1	21.6
23 Excluded revenues	(6.8)	(0.6)	(0.6)	(0.5)	(0.5)	(0.5)	(2.7)	(0.5)
24 Base price control revenue (before profiling)	282.4	363.0	353.6	359.9	358.3	365.5	1,800.2	360.0
25 Base price control revenue (after profiling)	-	306.3	332.2	360.3	390.7	423.7	1,813.2	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		28.5%	-2.6%	1.8%	-0.4%	2.0%		5.29%
28 Change as %age (Profiled)		8.5%	8.5%	8.5%	8.5%	8.5%		8.45%

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CE NEDL	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	803.6	826.8	861.0	892.4	926.9	962.3	4,469.3	893.9
2 Total RAV additions	92.0	107.6	109.3	115.3	119.0	115.9	567.3	113.5
3 Depreciation	68.8	73.4	78.0	80.7	83.7	86.5	402.4	80.5
4 Closing asset value	826.8	861.0	892.4	926.9	962.3	991.7	4,634.2	926.8
5 Present value of closing RAV	783.3	822.5	852.4	885.4	919.2	947.3	4,426.8	885.4
6 Allowance for change in RAV		4.4	8.7	7.1	7.9	15.3	43.5	8.7
Allowed costs								
7 Fast Pot	37.5	44.1	41.9	43.1	44.3	44.4	217.8	43.6
8 Depreciation	69.1	73.4	78.0	80.7	83.7	86.5	402.4	80.5
9 Pension deficit	-	15.5	15.5	15.5	15.5	15.5	77.6	15.5
10 Pension costs expensed	8.9	2.0	2.0	2.0	2.0	2.1	10.2	2.0
11 Return	38.7	38.6	40.1	41.6	43.2	44.7	208.4	41.7
12 Tax allowance	17.4	25.5	24.5	22.2	23.3	23.7	119.2	23.8
13 Capex Incentive Scheme	0.7	(0.2)	(0.7)	(0.9)	(0.4)	(0.0)	(2.2)	(0.4)
14 Losses Incentive Scheme	-	(2.4)	(2.7)	2.9	-	-	(2.2)	(0.4)
15 DPCR4 costs	4.0	5.5	5.1	-	-	-	10.5	2.1
16 Innovation Fund Incentive	0.8	0.8	0.9	0.9	0.9	1.0	4.6	-
17 Low Carbon Networks Fund	-	0.9	4.3	4.9	5.4	6.0	21.5	4.3
18 CI/CML Transmission exit charges	5.2	5.1	5.2	5.2	9.9	9.8	35.2	7.0
19 IQI incentive allowance, QOS adjustment	1.5	2.4	2.4	2.4	2.4	2.4	12.0	2.4
20 2009/10 volume driver	(10.6)	-	-	-	-	-	-	-
21 Total costs	173.4	211.2	216.7	220.6	230.4	236.0	1,114.9	223.0
Price Control Revenue								
22 Pass through costs	16.9	15.4	14.6	13.7	12.3	11.5	67.5	13.5
23 Excluded revenues	(1.4)	(0.2)	(0.2)	(0.1)	(0.1)	(0.1)	(0.7)	(0.1)
24 Base price control revenue (before profiling)	189.0	226.5	231.1	234.2	242.5	247.4	1,181.6	236.3
25 Base price control revenue (after profiling)	-	203.5	219.2	236.1	254.4	274.0	1,187.2	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		19.9%	2.0%	1.4%	3.5%	2.0%		5.54%
28 Change as %age (Profiled)		7.7%	7.7%	7.7%	7.7%	7.7%		7.71%

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CE YEDL	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	1,031.5	1,056.9	1,111.6	1,163.5	1,208.3	1,251.3	5,791.7	1,158.3
2 Total RAV additions	112.9	147.9	151.5	149.3	152.0	157.4	758.1	151.6
3 Depreciation	87.5	93.1	99.7	104.5	109.0	112.9	519.1	103.8
4 Closing asset value	1,056.9	1,111.6	1,163.5	1,208.3	1,251.3	1,295.9	6,030.7	1,206.1
5 Present value of closing RAV	1,001.4	1,061.9	1,111.4	1,154.2	1,195.3	1,237.9	5,760.8	1,152.2
6 Allowance for change in RAV		(5.1)	0.2	9.5	13.3	13.7	31.6	6.3
Allowed costs								
7 Fast Pot	45.2	55.2	53.9	53.0	53.9	55.8	271.7	54.3
8 Depreciation	88.5	93.1	99.7	104.5	109.0	112.9	519.1	103.8
9 Pension deficit	-	7.4	7.4	7.4	7.4	7.4	37.2	7.4
10 Pension costs expensed	5.4	2.2	2.4	2.4	2.4	2.4	11.9	2.4
11 Return	56.1	49.6	52.1	54.3	56.3	58.3	270.6	54.1
12 Tax allowance	30.6	36.3	35.6	31.0	32.2	33.0	168.1	33.6
13 Capex Incentive Scheme	(1.5)	0.7	1.2	(0.2)	(0.6)	(0.2)	0.8	0.2
14 Losses Incentive Scheme	-	(3.8)	(6.5)	8.3	-	-	(2.0)	(0.4)
15 DPCR4 costs	7.4	9.1	9.3	-	-	-	18.4	3.7
16 Innovation Fund Incentive	1.1	1.1	1.2	1.2	1.2	1.2	5.9	-
17 Low Carbon Networks Fund	-	1.2	6.2	7.0	7.8	8.6	30.9	6.2
18 CI/CML Transmission exit charges	10.4	10.0	11.7	10.0	10.0	10.0	51.7	10.3
19 IOI incentive allowance, QOS adjustment	1.9	3.6	3.6	3.6	3.6	3.6	17.9	3.6
20 2009/10 volume driver	(13.8)	-	-	-	-	-	-	-
21 Total costs	231.3	265.7	277.8	282.6	283.2	293.0	1,402.3	280.5
Price Control Revenue								
22 Pass through costs	22.8	22.6	22.6	22.6	22.6	22.6	113.1	22.6
23 Excluded revenues	(3.3)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.4)	(0.1)
24 Base price control revenue (before profiling)	250.8	288.3	300.4	305.2	305.8	315.5	1,515.0	303.0
25 Base price control revenue (after profiling)	-	267.1	284.5	303.0	322.7	343.7	1,521.0	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		14.9%	4.2%	1.6%	0.2%	3.2%		4.70%
28 Change as %age (Profiled)		6.5%	6.5%	6.5%	6.5%	6.5%		6.51%

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WPD S Wales	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	674.4	668.9	674.9	683.2	694.4	704.8	3,426.2	685.2
2 Total RAV additions	59.7	74.3	79.5	83.4	83.1	83.2	403.5	80.7
3 Depreciation	65.3	68.3	71.1	72.2	72.8	72.6	357.0	71.4
4 Closing asset value	668.9	674.9	683.2	694.4	704.8	715.3	3,472.7	694.5
5 Present value of closing RAV	633.7	644.7	652.7	663.4	673.2	683.3	3,317.3	663.5
6 Allowance for change in RAV		24.7	22.7	20.4	21.7	21.9	111.5	22.3
Allowed costs								
7 Fast Pot	35.2	36.2	35.7	35.8	35.5	37.6	180.7	36.1
8 Depreciation	65.4	68.3	71.1	72.2	72.8	72.6	357.0	71.4
9 Pension deficit	-	11.3	11.3	11.3	11.3	11.3	56.3	11.3
10 Pension costs expensed	5.2	1.5	1.6	1.7	1.7	1.7	8.1	1.6
11 Return	32.0	30.8	31.1	31.5	32.0	32.5	157.9	31.6
12 Tax allowance	19.6	25.5	25.0	24.1	24.3	24.8	123.8	24.8
13 Capex Incentive Scheme	(0.1)	0.2	0.2	0.2	0.3	0.1	1.0	0.2
14 Losses Incentive Scheme	-	(0.3)	1.4	2.4	-	-	3.5	0.7
15 DPCR4 costs	1.1	(6.3)	0.0	-	-	-	(6.3)	(1.3)
16 Innovation Fund Incentive	0.8	0.8	0.8	0.8	0.8	0.8	4.1	-
17 Low Carbon Networks Fund	-	0.6	3.0	3.4	3.8	4.1	14.9	3.0
18 CI/CML Transmission exit charges	4.4	6.6	6.6	7.2	7.2	7.2	34.8	7.0
19 IOI incentive allowance, QOS adjustment	1.3	6.6	6.6	6.6	6.6	6.6	33.2	6.6
20 2009/10 volume driver	(7.3)	-	-	-	-	-	-	-
21 Total costs	157.6	181.7	194.5	197.2	196.3	199.4	969.1	193.8
Price Control Revenue								
22 Pass through costs	16.9	14.7	14.7	14.7	14.7	14.7	73.6	14.7
23 Excluded revenues	(0.2)	-	-	-	-	-	-	-
24 Base price control revenue (before profiling)	174.3	196.5	209.2	211.9	211.0	214.1	1,042.7	208.5
25 Base price control revenue (after profiling)	-	185.0	196.5	208.6	221.5	235.1	1,046.7	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		12.7%	6.5%	1.3%	-0.4%	1.4%		4.20%
28 Change as %age (Profiled)		6.2%	6.2%	6.2%	6.2%	6.2%		6.17%

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WPD S West		09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
		Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08
Regulatory Asset Value (RAV)									
1	Opening asset value	902.1	914.3	938.1	970.4	1,004.4	1,038.2	4,865.5	973.1
2	Total RAV additions	91.0	107.0	119.8	123.6	125.8	125.5	601.7	120.3
3	Depreciation	78.7	83.3	87.4	89.6	92.0	94.9	447.2	89.4
4	Closing asset value	914.3	938.1	970.4	1,004.4	1,038.2	1,068.8	5,020.0	1,004.0
5	Present value of closing RAV	866.3	896.1	927.0	959.5	991.8	1,021.0	4,795.4	959.1
6	Allowance for change in RAV		18.7	11.3	11.2	13.0	17.6	71.8	14.4
Allowed costs									
7	Fast Pot	42.5	45.2	46.4	46.6	47.3	49.0	234.4	46.9
8	Depreciation	77.9	83.3	87.4	89.6	92.0	94.9	447.2	89.4
9	Pension deficit	-	20.0	20.0	20.0	20.0	20.0	99.8	20.0
10	Pension costs expensed	7.5	1.8	2.0	2.0	2.1	2.1	10.1	2.0
11	Return	43.4	42.4	43.7	45.2	46.8	48.2	226.3	45.3
12	Tax allowance	21.9	30.3	30.4	29.0	29.9	31.2	150.7	30.1
13	Capex Incentive Scheme	1.0	(0.2)	(0.4)	(0.2)	(0.1)	(0.0)	(0.9)	(0.2)
14	Losses Incentive Scheme	-	(4.1)	(5.9)	2.1	-	-	(7.9)	(1.6)
15	DPCR4 costs	5.5	(0.9)	0.3	-	-	-	(0.6)	(0.1)
16	Innovation Fund Incentive	1.0	1.0	1.0	1.1	1.1	1.1	5.3	-
17	Low Carbon Networks Fund	-	0.8	4.2	4.7	5.2	5.8	20.8	4.2
18	CI/CML, Transmission exit charges	7.3	6.6	6.6	7.2	7.2	7.2	34.8	7.0
19	IOI incentive allowance, QOS adjustment	1.8	9.1	9.1	9.1	9.1	9.1	45.5	9.1
20	2009/10 volume driver	(11.9)	-	-	-	-	-	-	-
21	Total costs	198.0	235.2	244.8	256.3	260.6	268.4	1,265.4	253.1
Price Control Revenue									
22	Pass through costs	22.2	19.4	18.3	17.1	15.2	13.9	83.9	16.8
23	Excluded revenues	(3.4)	-	-	-	-	-	-	-
24	Base price control revenue (before profiling)	216.8	254.6	263.1	273.5	275.7	282.3	1,349.3	269.9
25	Base price control revenue (after profiling)	-	233.1	250.7	269.6	289.9	311.8	1,355.1	-
26	Price Control Revenue for 2009-10 as forecast								Avg X
27	Change as %age (Unprofiled)		17.5%	3.3%	3.9%	0.8%	2.4%		5.43%
28	Change as %age (Profiled)		7.5%	7.5%	7.5%	7.5%	7.5%		7.54%

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EDFE LPN		09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
		Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08	Em 07/08
Regulatory Asset Value (RAV)									
1	Opening asset value	1,156.8	1,202.7	1,249.0	1,290.8	1,323.6	1,338.6	6,404.7	1,280.9
2	Total RAV additions	146.0	153.7	155.5	151.0	136.7	135.5	732.4	146.5
3	Depreciation	100.1	107.4	113.6	118.2	121.8	124.3	585.3	117.1
4	Closing asset value	1,202.7	1,249.0	1,290.8	1,323.6	1,338.6	1,349.8	6,551.8	1,310.4
5	Present value of closing RAV	1,139.5	1,193.1	1,233.1	1,264.4	1,278.7	1,289.4	6,258.6	1,251.7
6	Allowance for change in RAV		9.9	16.3	27.0	46.0	50.3	149.5	29.9
Allowed costs									
7	Fast Pot	45.4	57.2	56.8	55.9	54.1	54.7	278.7	55.7
8	Depreciation	104.8	107.4	113.6	118.2	121.8	124.3	585.3	117.1
9	Pension deficit	-	24.9	24.9	24.9	24.9	24.9	124.3	24.9
10	Pension costs expensed	11.0	1.6	1.6	1.6	1.6	1.5	8.0	1.6
11	Return	61.7	56.1	58.1	59.8	60.9	61.5	296.6	59.3
12	Tax allowance	29.8	29.6	29.9	28.7	29.6	30.7	148.4	29.7
13	Capex Incentive Scheme	0.1	(4.4)	1.0	(0.1)	(0.8)	(1.1)	(5.4)	(1.1)
14	Losses Incentive Scheme	-	6.6	(7.2)	(1.0)	-	-	(1.7)	(0.3)
15	DPCR4 costs	-	(3.2)	-	-	-	-	(3.2)	(0.6)
16	Innovation Fund Incentive	1.2	1.2	1.3	1.4	1.4	1.4	6.7	-
17	Low Carbon Networks Fund	-	1.2	6.2	6.9	7.7	8.5	30.5	6.1
18	CI/CML, Transmission exit charges	16.9	18.6	24.0	26.8	30.1	37.2	136.7	27.3
19	IOI incentive allowance, QOS adjustment	0.3	1.7	1.7	1.7	1.7	1.7	8.6	1.7
20	2009/10 volume driver	(11.8)	-	-	-	-	-	-	-
21	Total costs	259.3	298.4	311.9	324.8	332.9	345.4	1,613.4	322.7
Price Control Revenue									
22	Pass through costs	28.6	25.2	23.9	23.9	23.9	23.9	120.8	24.2
23	Excluded revenues	(3.8)	2.4	2.5	2.4	2.4	2.5	12.2	2.4
24	Base price control revenue (before profiling)	284.1	326.0	338.3	351.1	359.3	371.8	1,746.5	349.3
25	Base price control revenue (after profiling)	-	304.2	325.8	348.8	373.5	400.0	1,752.2	-
26	Price Control Revenue for 2009-10 as forecast								Avg X
27	Change as %age (Unprofiled)		14.8%	3.8%	3.8%	2.3%	3.5%		5.53%
28	Change as %age (Profiled)		7.1%	7.1%	7.1%	7.1%	7.1%		7.08%

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Electricity Distribution Price Control Review
Final Proposals – Allowed Revenues and Financial Issues

7 December 2009

EDFE SPN	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	928.2	1,007.5	1,078.4	1,145.3	1,200.3	1,249.3	5,680.8	1,136.2
2 Total RAV additions	155.1	154.4	157.2	149.8	147.9	155.7	764.9	153.0
3 Depreciation	75.7	83.5	90.3	94.8	98.9	102.5	470.0	94.0
4 Closing asset value	1,007.5	1,078.4	1,145.3	1,200.3	1,249.3	1,302.5	5,975.8	1,195.2
5 Present value of closing RAV	954.6	1,030.1	1,094.0	1,146.6	1,193.4	1,244.2	5,708.4	1,141.7
6 Allowance for change in RAV		(23.1)	(16.0)	(1.3)	7.0	5.2	(28.2)	(5.6)
Allowed costs								
7 Fast Pot	43.5	57.1	58.1	57.0	57.0	59.3	288.6	57.7
8 Depreciation	82.5	83.5	90.3	94.8	98.9	102.5	470.0	94.0
9 Pension deficit	-	20.4	20.4	20.4	20.4	20.4	102.2	20.4
10 Pension costs expensed	10.3	1.9	1.8	1.8	1.8	1.8	9.1	1.8
11 Return	53.1	47.7	50.9	53.7	56.1	58.4	266.8	53.4
12 Tax allowance	17.4	18.7	21.7	20.5	21.9	22.7	105.5	21.1
13 Capex Incentive Scheme	(3.2)	(7.7)	3.2	(0.9)	(1.8)	(1.0)	(8.2)	(1.6)
14 Losses Incentive Scheme	-	15.8	(2.6)	(1.6)	-	-	11.6	2.3
15 DPCR4 costs	5.1	(7.9)	0.3	-	-	-	(7.6)	(1.5)
16 Innovation Fund Incentive	0.9	0.9	1.0	1.1	1.1	1.2	5.3	-
17 Low Carbon Networks Fund	-	1.2	6.2	7.0	7.7	8.5	30.6	6.1
18 CI/CML Transmission exit charges	8.5	8.5	9.4	11.7	18.6	17.7	65.9	13.2
19 IOI incentive allowance, QOS adjustment	0.2	1.8	1.8	1.8	1.8	1.8	9.0	1.8
20 2009/10 volume driver	(6.5)	-	-	-	-	-	-	-
21 Total costs	211.8	242.0	262.5	267.3	283.6	293.3	1,348.7	269.7
Price Control Revenue								
22 Pass through costs	9.4	9.6	10.8	12.4	14.9	15.6	63.2	12.6
23 Excluded revenues	(1.9)	1.1	1.2	1.2	1.1	1.2	5.8	1.2
24 Base price control revenue (before profiling)	219.3	252.6	274.5	280.9	299.6	310.0	1,417.6	283.5
25 Base price control revenue (after profiling)	-	238.6	259.6	282.4	307.2	334.3	1,422.1	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		15.2%	8.6%	2.3%	6.6%	3.5%		7.17%
28 Change as %age (Profiled)		8.8%	8.8%	8.8%	8.8%	8.8%		8.79%

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EDFE EPN	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	1,550.4	1,659.4	1,752.5	1,824.2	1,883.6	1,933.8	9,053.5	1,810.7
2 Total RAV additions	235.5	231.3	220.1	214.9	214.0	223.0	1,103.2	220.6
3 Depreciation	126.5	138.2	148.3	155.5	163.8	171.6	777.5	155.5
4 Closing asset value	1,659.4	1,752.5	1,824.2	1,883.6	1,933.8	1,985.2	9,379.3	1,875.9
5 Present value of closing RAV	1,572.3	1,674.1	1,742.6	1,799.3	1,847.2	1,896.4	8,959.5	1,791.9
6 Allowance for change in RAV		(15.0)	10.1	25.5	37.2	38.3	96.2	19.2
Allowed costs								
7 Fast Pot	71.5	82.6	80.7	79.1	79.5	81.7	403.5	80.7
8 Depreciation	133.0	138.2	148.3	155.5	163.8	171.6	777.5	155.5
9 Pension deficit	-	7.2	7.2	7.2	7.2	7.2	36.0	7.2
10 Pension costs expensed	6.3	2.8	2.7	2.7	2.7	2.8	13.8	2.8
11 Return	77.1	78.1	81.9	84.9	87.4	89.7	421.9	84.4
12 Tax allowance	33.5	30.5	29.8	28.8	31.2	33.7	154.0	30.8
13 Capex Incentive Scheme	(0.6)	(7.3)	(3.8)	(6.6)	(5.9)	(3.0)	(26.5)	(5.3)
14 Losses Incentive Scheme	-	12.7	(2.0)	(31.4)	-	-	(20.7)	(4.1)
15 DPCR4 costs	7.5	(1.8)	0.7	-	-	-	(1.1)	(0.2)
16 Innovation Fund Incentive	1.5	1.5	1.6	1.7	1.6	1.8	8.1	-
17 Low Carbon Networks Fund	-	1.9	9.7	10.9	12.1	13.3	47.9	9.6
18 CI/CML Transmission exit charges	13.5	16.2	19.6	22.7	23.7	26.9	109.1	21.8
19 IOI incentive allowance, QOS adjustment	0.4	2.6	2.6	2.6	2.6	2.6	12.9	2.6
20 2009/10 volume driver	(13.0)	-	-	-	-	-	-	-
21 Total costs	330.7	365.2	379.0	358.1	405.8	428.1	1,936.3	387.3
Price Control Revenue								
22 Pass through costs	32.3	33.6	34.8	34.8	34.8	34.8	172.7	34.5
23 Excluded revenues	(2.2)	1.9	1.8	1.9	1.8	1.9	9.3	1.9
24 Base price control revenue (before profiling)	360.7	400.6	415.6	394.8	442.5	464.8	2,118.3	423.7
25 Base price control revenue (after profiling)	-	380.4	401.2	423.1	446.2	470.6	2,121.6	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		11.1%	3.7%	-5.0%	12.1%	5.0%		5.20%
28 Change as %age (Profiled)		5.5%	5.5%	5.5%	5.5%	5.5%		5.46%

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Electricity Distribution Price Control Review
Final Proposals – Allowed Revenues and Financial Issues

7 December 2009

SP Distribution	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	1,325.9	1,283.3	1,288.5	1,300.1	1,314.5	1,333.6	6,520.0	1,304.0
2 Total RAV additions	96.4	116.6	123.7	128.5	135.7	132.3	636.8	127.4
3 Depreciation	139.0	111.4	112.2	114.1	116.5	119.0	573.1	114.6
4 Closing asset value	1,283.3	1,288.5	1,300.1	1,314.5	1,333.6	1,346.9	6,583.6	1,316.7
5 Present value of closing RAV	1,215.9	1,230.9	1,241.9	1,255.6	1,274.0	1,286.7	6,289.0	1,257.8
6 Allowance for change in RAV		53.6	47.7	45.5	41.4	48.1	236.3	47.3
Allowed costs								
7 Fast Pot	48.6	45.6	48.1	48.0	49.9	49.1	240.7	48.1
8 Depreciation	138.9	111.4	112.2	114.1	116.5	119.0	573.1	114.6
9 Pension deficit	-	7.6	7.6	7.6	7.6	7.6	37.8	7.6
10 Pension costs expensed	2.4	1.9	2.0	2.0	2.0	2.0	9.9	2.0
11 Return	68.7	58.9	59.3	59.9	60.6	61.4	300.0	60.0
12 Tax allowance	50.7	25.3	17.0	16.4	18.3	19.1	96.1	19.2
13 Capex Incentive Scheme	1.3	(0.2)	3.2	2.3	1.9	1.0	8.2	1.6
14 Losses Incentive Scheme	-	(1.9)	(0.1)	6.3	-	-	4.2	0.8
15 DPCR4 costs	-	21.4	0.5	-	-	-	21.9	4.4
16 Innovation Fund Incentive	1.4	1.4	1.3	1.2	1.2	1.2	6.4	-
17 Low Carbon Networks Fund	-	1.1	5.5	6.2	6.9	7.6	27.4	5.5
18 CI/CML Transmission exit charges	12.6	11.8	12.1	12.0	12.4	12.6	60.9	12.2
19 IOI incentive allowance, QOS adjustment	0.7	1.6	1.6	1.6	1.6	1.6	7.9	1.6
20 2009/10 volume driver	(12.8)	-	-	-	-	-	-	-
21 Total costs	312.5	285.8	270.1	277.5	278.9	282.1	1,394.5	278.9
Price Control Revenue								
22 Pass through costs	40.3	32.3	32.3	32.3	32.3	32.3	161.3	32.3
23 Excluded revenues	-	-	-	-	-	-	-	-
24 Base price control revenue (before profiling)	352.8	318.1	302.4	309.8	311.1	314.4	1,555.8	311.2
25 Base price control revenue (after profiling)	-	337.7	323.2	309.3	296.0	283.3	1,549.5	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		-9.8%	-4.9%	2.4%	0.4%	1.0%		-2.28%
28 Change as %age (Profiled)		-4.3%	-4.3%	-4.3%	-4.3%	-4.3%		-4.29%

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SP Manweb	09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)								
1 Opening asset value	1,061.9	1,081.9	1,146.3	1,199.3	1,259.9	1,310.1	5,997.5	1,199.5
2 Total RAV additions	107.0	156.7	152.3	165.1	159.3	160.8	794.0	158.8
3 Depreciation	86.9	92.3	99.3	104.4	109.1	112.4	517.5	103.5
4 Closing asset value	1,081.9	1,146.3	1,199.3	1,259.9	1,310.1	1,358.4	6,274.0	1,254.8
5 Present value of closing RAV	1,025.1	1,095.0	1,145.6	1,203.6	1,251.5	1,297.6	5,993.3	1,198.7
6 Allowance for change in RAV		(13.4)	0.7	(4.3)	8.7	12.8	4.4	0.9
Allowed costs								
7 Fast Pot	40.4	55.5	55.4	57.1	56.1	56.7	280.8	56.2
8 Depreciation	85.8	92.3	99.3	104.4	109.1	112.4	517.5	103.5
9 Pension deficit	-	13.9	13.9	13.9	13.9	13.9	69.3	13.9
10 Pension costs expensed	7.8	2.2	2.2	2.2	2.2	2.2	11.2	2.2
11 Return	46.3	51.0	53.7	56.3	58.8	61.1	280.9	56.2
12 Tax allowance	17.3	24.3	17.7	12.4	12.9	13.5	80.8	16.2
13 Capex Incentive Scheme	(1.3)	(3.2)	5.3	4.1	2.9	1.7	10.8	2.2
14 Losses Incentive Scheme	-	(5.9)	(7.4)	(0.2)	-	-	(13.5)	(2.7)
15 DPCR4 costs	-	29.7	13.8	-	-	-	43.5	8.7
16 Innovation Fund Incentive	0.9	0.9	1.2	1.1	1.1	1.2	5.5	-
17 Low Carbon Networks Fund	-	0.8	4.1	4.6	5.1	5.7	20.3	4.1
18 CI/CML Transmission exit charges	10.8	9.2	9.3	9.4	9.4	9.5	46.8	9.4
19 IOI incentive allowance, QOS adjustment	0.6	2.0	2.0	2.0	2.0	2.0	10.1	2.0
20 2009/10 volume driver	(11.6)	-	-	-	-	-	-	-
21 Total costs	197.0	272.6	270.4	267.5	273.7	279.8	1,364.0	272.8
Price Control Revenue								
22 Pass through costs	14.6	17.2	16.5	15.7	14.5	14.1	78.0	15.6
23 Excluded revenues	(1.6)	-	-	-	-	-	-	-
24 Base price control revenue (before profiling)	209.9	289.8	286.9	283.2	288.1	294.0	1,442.0	288.4
25 Base price control revenue (after profiling)	-	233.2	259.1	287.9	319.9	355.4	1,455.5	-
26 Price Control Revenue for 2009-10 as forecast								Avg X
27 Change as %age (Unprofiled)		38.1%	-1.0%	-1.3%	1.7%	2.0%		6.97%
28 Change as %age (Profiled)		11.1%	11.1%	11.1%	11.1%	11.1%		11.10%

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SSE Hydro		09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
		£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)									
1	Opening asset value	815.7	837.9	845.6	849.7	851.6	851.0	4,235.9	847.2
2	Total RAV additions	87.2	81.0	78.4	78.1	77.3	80.8	395.6	79.1
3	Depreciation	65.0	73.3	74.3	76.2	77.9	79.1	380.8	76.2
4	Closing asset value	837.9	845.6	849.7	851.6	851.0	852.7	4,250.7	850.1
5	Present value of closing RAV	793.9	807.8	811.7	813.5	812.9	814.5	4,060.5	812.1
6	Allowance for change in RAV		30.8	34.7	37.1	39.6	37.4	179.5	35.9
Allowed costs									
7	Fast Pot	33.0	38.4	37.8	34.8	34.8	35.9	181.6	36.3
8	Depreciation	65.7	73.3	74.3	76.2	77.9	79.1	380.8	76.2
9	Pension deficit	-	11.8	11.8	11.8	11.8	11.8	58.9	11.8
10	Pension costs expensed	2.0	1.8	1.8	1.8	1.8	1.8	9.2	1.8
11	Return	46.9	38.5	38.8	39.0	39.0	39.0	194.3	38.9
12	Tax allowance	28.9	25.4	22.7	20.9	21.6	22.1	112.7	22.5
13	Capex Incentive Scheme	1.0	3.2	0.3	(0.8)	(0.9)	(0.6)	1.3	0.3
14	Losses Incentive Scheme	-	1.4	1.3	1.3	-	-	4.0	0.8
15	DPCR4 costs	1.4	4.1	0.3	-	-	-	4.3	0.9
16	Innovation Fund Incentive	0.9	0.9	1.0	0.9	0.9	0.9	4.7	-
17	Low Carbon Networks Fund	-	0.4	2.0	2.3	2.5	2.8	10.0	2.0
18	CI/CML, Transmission exit charges	6.5	9.7	11.0	12.4	12.8	13.8	59.7	11.9
19	IQI incentive allowance, QOS adjustment	1.5	4.3	4.3	4.3	4.3	4.3	21.3	4.3
20	2009/10 volume driver	(4.2)	-	-	-	-	-	-	-
21	Total costs	183.5	213.2	207.3	204.9	206.5	210.9	1,042.8	208.6
Price Control Revenue									
22	Pass through costs	25.9	28.4	28.4	28.4	28.4	28.4	142.2	28.4
23	Excluded revenues	(0.6)	(0.5)	(0.5)	(0.4)	(0.4)	(0.4)	(2.2)	(0.4)
24	Base price control revenue (before profiling)	208.9	241.1	235.2	232.9	234.5	238.9	1,182.7	236.5
25	Base price control revenue (after profiling)	-	217.9	227.3	237.1	247.3	258.0	1,187.6	-
26	Price Control Revenue for 2009-10 as forecast								Avg X
27	Change as %age (Unprofiled)		15.5%	-2.4%	-1.0%	0.7%	1.9%		2.73%
28	Change as %age (Profiled)		4.3%	4.3%	4.3%	4.3%	4.3%		4.32%

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SSE Southern		09-10	10-11	11-12	12-13	13-14	14-15	DPCR5 Total	5 yr avg
		£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08	£m 07/08
Regulatory Asset Value (RAV)									
1	Opening asset value	1,611.6	1,653.5	1,700.4	1,741.2	1,782.7	1,817.4	8,695.2	1,739.0
2	Total RAV additions	187.7	202.2	204.5	209.5	206.1	199.0	1,021.2	204.2
3	Depreciation	145.9	155.3	163.7	168.0	171.4	173.3	831.7	166.3
4	Closing asset value	1,653.5	1,700.4	1,741.2	1,782.7	1,817.4	1,843.0	8,884.7	1,776.9
5	Present value of closing RAV	1,566.6	1,624.3	1,663.3	1,702.9	1,736.1	1,760.5	8,487.1	1,697.4
6	Allowance for change in RAV		29.8	38.0	39.2	47.7	58.2	212.9	42.6
Allowed costs									
7	Fast Pot	60.4	75.3	75.9	74.2	73.6	72.3	371.3	74.3
8	Depreciation	152.6	155.3	163.7	168.0	171.4	173.3	831.7	166.3
9	Pension deficit	-	29.3	29.3	29.3	29.3	29.3	146.3	29.3
10	Pension costs expensed	15.0	2.3	2.3	2.3	2.3	2.3	11.4	2.3
11	Return	85.1	76.8	78.8	80.7	82.4	83.8	402.4	80.5
12	Tax allowance	49.4	45.2	45.8	43.5	43.6	42.6	220.6	44.1
13	Capex Incentive Scheme	0.2	3.0	4.1	0.1	(1.7)	(1.2)	4.3	0.9
14	Losses Incentive Scheme	-	1.7	2.0	1.8	-	-	5.5	1.1
15	DPCR4 costs	6.9	(3.7)	0.5	-	-	-	(3.2)	(0.6)
16	Innovation Fund Incentive	1.7	1.7	1.8	1.9	1.9	1.9	9.1	-
17	Low Carbon Networks Fund	-	1.6	8.0	9.0	10.0	11.0	39.7	7.9
18	CI/CML, Transmission exit charges	10.1	12.3	12.3	12.3	12.7	12.7	62.3	12.5
19	IQI incentive allowance, QOS adjustment	3.2	5.3	5.3	5.3	5.3	5.3	26.6	5.3
20	2009/10 volume driver	(14.7)	-	-	-	-	-	-	-
21	Total costs	369.9	406.0	429.7	428.2	430.8	433.4	2,128.1	425.6
Price Control Revenue									
22	Pass through costs	46.2	40.9	38.4	37.0	37.0	37.0	190.4	38.1
23	Excluded revenues	(2.2)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(1.3)	(0.3)
24	Base price control revenue (before profiling)	413.8	446.6	467.9	465.0	467.5	470.1	2,317.1	463.4
25	Base price control revenue (after profiling)	-	429.9	446.6	463.9	481.9	500.6	2,323.0	-
26	Price Control Revenue for 2009-10 as forecast								Avg X
27	Change as %age (Unprofiled)		7.9%	4.8%	-0.6%	0.6%	0.6%		2.58%
28	Change as %age (Profiled)		3.9%	3.9%	3.9%	3.9%	3.9%		3.88%

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Appendix 1 – Summary of responses to the third pension consultation document

Chapter summary

This chapter provides a brief summary of the consultation responses to our third pension consultation document which was published in October 2009.

1.1. As with the previous two rounds of consultation, the preference of NWOs and the unions remains unchanged, namely to retain the status quo. NWOs provided constructive comments on the methodologies we set out, were we to adopt our minded to position. NWOs consider that they are adequately incentivised by the existing arrangements, whilst, conversely, customers argue that NWOs can do more to reduce pension costs and support some form of incentivisation. Whilst it was generally recognised that a trigger for a full efficiency review is desirable, the consensus was that using movements in the constituent elements of the PPF 7800 index as a trigger was not appropriate for that purpose.

1.2. All the responses to our third pension consultation document and the presentations at our third pension seminar on 9 November 2009 are available on our website¹⁷.

Chapter three

Do you agree that applying benchmarking to all employment costs (including ongoing pension costs) appropriately incentivises NWOs to manage those costs efficiently?

1.3. Consumers supported benchmarking, whereas six NWOs were against benchmarking total pension costs alone and some were not sure that using total employment costs would be a reasonable alternative. Benchmarking of DB schemes was not considered appropriate because of protected persons. It was suggested that all comparisons need to be appropriate to the industry and conducted at the same date.

¹⁷ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=88&refer=Networks> and <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=87&refer=Networks>

1.4. Some respondents said that more detail on the mechanisms was required in order to allow them to consider and respond to our proposals in-depth.

Views are invited on whether our proposed treatment for DPCR5 is appropriate?

1.5. Consumers were supportive, although NWOs and others were less so. Generally, the NWOs do not see the need for change and would have preferred the proposals to be set out in greater detail in order to allow them to consider and respond to our proposals in-depth.

1.6. One respondent expressed concern that the DPCR5 timetable allowed limited time for consideration of changes. In view of this, they considered that the current arrangements (which they regarded as a pass through) should continue.

What do you think would be an appropriate sharing factor to apply to ongoing pension costs in DPCR5?

1.7. A variety of views were expressed, but with little consensus. Some believe a sharing factor is not required where costs cannot be controlled. However, were one to be used, two DNOs suggested a sharing factor of between 10 to 20 per cent, while consumers suggested capping the upside for NWOs at 25 per cent.

Do you agree with the proposal to introduce a notional deficit repair period for all network companies?

1.8. This proposal was supported in principle by a majority of respondents, although some had reservations and some were opposed.

Views are invited on whether 15 years is the appropriate notional funding period to protect consumers, or whether we should set 10 years as the minimum, or use a figure between these two numbers.

1.9. NWOs preferred shorter periods with a maximum of 10 years (some citing remaining active service life) as achievable, whilst consumers suggested 15 years was realistic in view of the state of the markets. The unions saw this as an intrusion into pension scheme regulation and trustees saw it as a weakening of the employer's covenant and only acceptable if the pension principles were enduring and Ofgem gave a clear and unambiguous commitment to fully fund the deficits.

Views are invited on whether using the latest updated, rather than the last full, valuation is the most appropriate given the recent volatile market conditions.

1.10. Eight NWOs supported using the latest updated valuation with some supporting the use of the last full valuation if undertaken within 12 months of the price control commencing. Trustees stated that their most likely approach would be to base their

funding decisions on the surplus or deficit at the date of the formal valuation. Therefore, the results of the last formal valuation should be used if they are within the last 12 months, or a recent update where the formal valuation is at an earlier date.

Do you agree with our proposal to introduce a trigger for a review of the efficiency of companies' pension costs at the end of each price control period?

1.11. Consumers supported a trigger whilst the NWOs suggested that, as movements in deficits were outside a company's control, a trigger was inappropriate.

1.12. Concern was expressed that the term 'efficiency' had not been defined.

1.13. Respondents were not clear how their costs would be impacted if the trigger was breached.

Views are invited as to whether the PPF7800 index is an appropriate index to use as the trigger mechanism for a review of deficit movement.

1.14. All respondents apart from consumers considered that the PPF7800 index was not appropriate for a variety of reasons (although an actuary whilst considering the PPF7800 index far from perfect, suggested that there were few alternatives). Most NWOs and one union suggested that a report from GAD addressing efficiency would be appropriate.

1.15. One actuary suggested a 'shadow' pension scheme, with representative liabilities and assets created and updated by GAD for comparison purposes.

Do you think our minded to position overall achieves an appropriate balance between our duties to protect consumers and allows NWOs appropriate funding of pension deficits?

1.16. Consumers expressed disappointment that stronger incentives for deficits had not been proposed.

1.17. Six NWOs disagreed and commented that too many issues were undefined and that the proposals appeared to transfer risk to the NWOs. A lack of detail in the practical application of issues was also highlighted.

Chapter four

Views are invited on our minded to position on the application issues and whether these provide the necessary clarity.

1.18. There were few specific responses. One NWO suggested that the consultation failed to provide clarity on efficiency, benchmarking or deficit true-up. Concern was expressed at the scaling of pensions.

Views are invited on the logic of the methodology for rolling forward unfunded ERDCs in principle 6.

1.19. Most respondents did not answer this question. Two NWOs agreed with the methodology, albeit one with caveats.

Views are invited on whether ring-fencing movement in deficits related to bulk transfers in is appropriate in all circumstances.

1.20. There was general consensus that this is not appropriate in all cases and should be reviewed case by case.

Other comments made by respondents

1.21. Consumers were supportive of the overall proposals, with one suggesting we had not gone far enough.

1.22. The general view from NWOs was that the existing price control pension principles were fit for purpose and did not need to change. The principles should be enduring and Ofgem should confirm their commitment to these principles. In addition, if these principles were to change, any changes should not be applied retrospectively.

1.23. NWOs were said to have limited influence on pension funds and this, together with the effect of protected persons legislation, had not been adequately recognised in the consultation document.

1.24. The GAD report showed schemes were efficient so there is no need to incentivise or change.

1.25. A number of respondents expressed concern that sufficient time had not been given to review the proposals and that the consultation itself did not supply sufficient detail to allow considered replies to be made.

Seminar on 9 November 2009

The seminar was well attended with attendees from all stakeholders. Presentations were made by Ofgem on our minded to proposals, the Energy Networks Association, Prospect and the Energy Intensive Users Group. Each presenter explained their view on the proposals, which were aligned with their subsequent written responses. The atmosphere was constructive with a great deal of questions and comment from across the floor. This enabled clarification on our proposals to be given and suggestions on the methodologies to be proposed, particularly for the deficit review trigger.

Appendix 2 - Price Control Pension Principles

Introduction

1.26. We set out below the updated application of the pension principles based on our final position for DPCR5. Some of the previous principles remain valid for the TPCR4 and GDPCR reviews and have not been amended. The clarifications herein are for guidance for these reviews.

1.1. Clarifications introduced are:

- Pension administration costs,
- Pension Protection Fund levies,
- Stranded Surplus,
- Buy-ins and buy-outs,
- Unexpected lump sum deficit payments,
- The treatment of movements in ERDCs, and
- When the regulatory fraction may be revised.

Defined Benefit schemes

Principle 1 - Efficient and Economic Employment and Pension Costs

Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.

1.2. Consumers should not be expected to pay the excess costs of providing benefits that are out of line with the wider private sector practice, nor for excess costs avoidable by efficient management action. We will, if appropriate, benchmark total employment costs, to ensure companies have correct incentives to manage their costs, including pension costs, efficiently.

Pension administration costs

1.3. We will standardise the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions to the scheme in setting allowances. In future, we will treat both as pension costs. We retain the option to incentivise these costs separately but given their relative immateriality, we are unlikely to do so unless there are signs that NWOs are failing to exert control over these costs.

1.4. These costs form part of the ongoing pension costs subject to the sharing factor in DPCR5 and at subsequent controls, the IQI incentive regime.

Pension Protection Fund Levy

1.5. There are a number of elements to the levy, the largest is risk based. This has been seen to be the highest cost element and is dependent on the requirements of the PPF. As such, its magnitude is partly outside the control of sponsors and trustees. We will continue to monitor the actions taken to mitigate the cost of the risk based element of the levy where they can affect the levels, e.g. their Dun & Bradstreet Failure Scores (used to measure a company's insolvency risk) where a low score contributes to higher rate of the levy. We reserve the option to make adjustments on a case-by-case basis where the charge appears excessive compared to peers or there is evidence to indicate inefficiency in managing this cost.

1.6. These costs form part of the ongoing pension costs subject to the sharing factor in DPCR5 and at subsequent controls, the IQI incentive regime.

Stranded surplus

1.7. In the event that a surplus arises (i.e. assets exceed the full buy-out cost of accrued liabilities), it is the trustees that have the power to decide whether it is in the interests of scheme members to repay it to the employer in accordance with the scheme rules and other legal requirements. Trustees have obligations to protect scheme members, and are likely to use any surplus in de-risking their investment strategy. If this was the case consumers may not benefit, although they, together with scheme members and sponsors, would have contributed to it.

1.8. We will monitor each scheme's position on an annual basis. If a scheme were in surplus for a given period, we consider it is a reasonable expectation for symmetry in the treatment for funding of deficits. We would therefore expect to share the benefit across members and consumers. We would consider our options when setting allowances such that consumers would benefit and the shareholders would cover the cost if contribution levels were not adjusted. We do not consider that reducing risk is always efficient if it leads to higher funding and deficits. Each instance will be reviewed on a case-by-case basis.

Buy-ins /buy-outs of pension schemes

1.9. These currently fall within the scope of Principles 1, 2 and 5. Buy-ins/buy-outs are effectively a de-risking of future liabilities. It is necessary to determine how such de-risking should be funded, to facilitate efficient management of the schemes and to remove uncertainty as to the regulatory treatment. It is difficult to be prescriptive as to how they should be spread between different generations of consumers. For guidance, an equitable option is to spread these costs over the same deficit repair period that is

used in setting ex ante allowances. We will deal with these, if they occur, applying the existing principles on a case-by-case basis.

Principle 2 - Attributable Regulated Fraction Only

Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in a price control.

1.10. It is for shareholders, rather than consumers of the regulated services, to fund liabilities associated with businesses carried on by the wider non-regulated group. This includes businesses that were formerly carried on by the same ownership group and have been sold, separated and/or ceased to be subject to the main Price Control review. In principle this may include costs related to self-financing excluded services, distributed generation, metering, de minimis activities of the NWO and of unregulated businesses in the same scheme, de minimis business and excluded services (which are self-financing) in the context of a transportation and/ or distribution price control. However, in some cases, the costs of such businesses are not readily separable from the regulated business and so they are dealt with on a case-by-case basis.

1.11. At DPCR4, there was a general assumption of a 20 per cent disallowance for non-regulated activities for most licensees. For DPCR5, we will retain this split as a starting point. At TPCR4, only the proportion of ongoing contributions and existing deficit that related to unregulated activities was disallowed. In GDPCR, a small adjustment was made in respect of pensions relating to the metering business.

1.12. The regulatory fraction determined in setting allowances will be reviewed to assess the ex post adjustment when there have been structural changes to a scheme, at each full valuation within a price control period and for setting ex ante allowances at each price control. We will also review and adjust for movements, including cash funding by sponsors to the previously unfunded ERDCs.

1.13. Structural changes may occur when:

- schemes merge or demerge,
- members are transferred in or out in bulk,
- there is a change of ultimate controller, and
- there is a buy-in/buy-out of any part of the scheme membership.

1.14. The non-regulated component of pension liabilities should logically reduce over time in a closed pension scheme for a predominantly wires or pipes only business. Thus, the allowed regulated fraction should increase. This will be calculated by determining the liabilities attributed to the active scheme members in the regulated business and the movement from the position determined at the previous price control. For DNOs this will over time, move the fraction to their actual attribution (where supported by the necessary records) from the 80:20 pragmatic split at DPCR4. The methodology is set out

in Chapter 10 of the Financial Methodologies document. This element of the regulatory fractions is only reset at the start of each price control period for setting ex ante allowances. It does not apply in the calculation of any ex post adjustment.

1.15. We expect NWOs to maintain appropriate records to enable this assessment. In the absence of detailed records, we will apply our own judgement. We will revise the allowed proportion and apply it within a price control period for computing the ex post adjustments and updating RAV where deficits are part of additions to RAV.

1.16. We will review each occurrence on its merits and would expect companies to approach us at an early stage to discuss the possible impact on their ex post adjustments. We will not specifically require an actuarial assessment and valuation at each trigger point above to determine the revised allowed proportion, as we recognise that it is not necessarily cost effective for NWOs to have an annual actuarial assessment of this split. If one exists, we will use it to inform the assessment.

1.17. The regulatory fraction will be reviewed at each subsequent price control using the basis in the previous control as a starting point and allowing for structural changes as set out above. For example, in DPCR5 this would be the 80/20 split adopted for most companies at DPCR4.

Bulk transfers

1.18. During a price control period there may be bulk transfers of members in or out of a DB scheme through corporate activity. These transfers are usually only accepted when the transfer value finances the deficit, if any, of the transferees. Bulk transfers in to a scheme have to be approved by trustees and as specified by the Pension Regulator, have to be fully funded (in all but exceptional circumstances). TPR guidance states: "There is no statutory obligation for a trust-based scheme to accept transfers-in and provide benefits in exchange. Some schemes do offer defined benefit transfer credits, typically in the form of 'added years' counting for benefits on the scheme's normal formula. Other schemes offer money purchase benefits in exchange for transfers, in which case no issues arise as to assumptions for determining benefits"; and that, "A transfer credit should not be expected to require additional funding from the employer in the long term unless agreed by the employer in advance." Under the Protected Person's legislation, a scheme has to accept a transfer of a protected person. We consider that movements in deficits arising from bulk transfers that result from corporate transactions, whether fully funded or not, should be a risk for shareholders and not consumers. This applies even where the transferred protected person's pension liability is underfunded where it arises from a corporate transaction.

1.19. Whilst transfers in may be accepted and some may include protected persons who may or may not be considered part of the regulated activities, it is considered that in order to control future deficits that shareholders, not consumers should fund any increase related to the transferees at future price controls.

1.20. This clarification covers only bulk transfers where individuals or groups of individuals (but not whole, or, substantially whole schemes) are transferred as part of a smaller transaction to acquire an activity rather than a licensee. A full merger between two existing DB schemes as a result of a corporate transaction is therefore excluded and will be dealt as a structural change (see above).

1.21. We cannot predict whether this treatment will be equitable to all situations. If we are satisfied that there are exceptional circumstances, we retain the option to deal with these on a case-by-case basis.

Principle 3 - Stewardship - Ante/Post Investment

Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship.

1.22. Any excess costs arising from material failure in the responsibility for taking good care of pension scheme resources so entrusted will be disallowed. Examples might include items such as recklessness, negligence, fraud or breach of fiduciary duty, though, since the pensions principles were established, the Pensions Act 2004 introduced a requirement that trustees should have knowledge and understanding of the law of trusts and pensions and principles of funding and investment. This should mean it is less likely that we will encounter poor stewardship issues. We will review stewardship and reserve our position to make adjustments to allowances if we observe, for example, any of the following:

- poor investment returns over a long period, e.g. greater than a single price control,
- whether the scheme investment managers are underperforming against their peers or the market and expectations and their performance has not been reviewed or benchmarked at appropriate intervals,
- not matching investment/returns to fund future liabilities as they fall due,
- material increase in deficits and need for increasing the funding,
- maintaining a higher balance of investments in riskier assets compared to investment returns which do not match future liabilities,
- accepting transfers in at under value, and
- making transfers out at over value.

1.23. In determining whether pension costs are reasonable, we may compare the level of funding rate recommended by periodic actuarial valuations to the actual funding rate adopted by the licensee. As long as a funding valuation uses actuarial assumptions which are in line with best practice the costs will be allowed in full, subject to any incentivisation adjustment. This is one indicator of whether there has been a material failure in

stewardship. We will also examine investment and administration costs to see whether these are materially out of line with industry figures.

1.24. It is recognised that the choice of investment strategy is one for trustees and necessarily involves the exercise of judgement, which, for any particular scheme and at any particular point in time, the trustees are best placed to make. These pension principles make clear that we do not think it is appropriate, given our statutory remit, for us to make judgements about investment strategies. In particular, the success or otherwise of any particular strategy can only be measured in hindsight, whereas trustees must make ex ante choices. Moreover, the strategy, which optimises outcomes over the whole life of a scheme, may produce inferior results over any particular shorter period (and vice versa). Therefore, it would be inappropriate for us to make judgements about investment strategies based on outcomes over the five-year period of a price control.

Principle 4 - Actuarial Valuation/Scheme Specific Funding

Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.

1.25. We expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables. Licensees are required to provide up-to-date actuarial calculations (including the most recent formal actuarial valuation of the relevant schemes) to support their cost estimates. We would expect and may request that, where the timing of valuations does not align with price control periods, companies obtain updated valuations as close as possible to the end of the price control as is practical given the timing of setting the Final Proposals.

1.26. We would not expect substantial differences between companies. However, if in any case there is one or more marked outlier, we will investigate the reasons for this. If these investigations reveal evidence of material differences and these differences have contributed to an increase in funding required, we may adjust the recommended funding rate for the purposes of setting the price control.

Principle 5 - Under Funding/Over Funding

In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis.

1.27. Typically, actuarial valuations of pension funds are carried out triennially. In contrast, price controls are typically set for periods of five years. Accordingly, it is possible that funding rates will change during the period of a price control. In practice with scheme-specific funding and the Pension Act 2004 requirement for annual valuations it is possible that individual or scheme specific events may bring forward valuation dates. There were two such cases in DPCR4.

1.28. In our decision for DPCR5, we have set a trigger mechanism for clarifying when we would either true up to actual cash costs or subject them to a review to assess the quantum of costs that we would true up ex post. In principle we will apply the following guidelines:

1. We will log up the cumulative effect and pass the impact through to consumers when setting the price control at subsequent reviews subject to determining that such costs comply with Principle one being both economic and efficient and subject to the incentive mechanism applicable at each control.
2. In assessing the quantum, adjustments may be made where the costs are not determined to be both economic and efficient in line with Principle one.
3. Subject to any applicable incentive mechanism, we will reflect differences (if any) between the allowances made in setting previous price controls and the actual employer contributions made to pension funds over the same period.
4. To the extent that actual contributions in any period fall short of or exceed the assumed contribution, these will be dealt with in accordance with the appropriate incentive mechanism.
5. Where there is a material difference between the assumptions proposed by different actuaries and agreed by the boards of regulated networks, and therefore the costs paid by different groups of consumers vary materially, this will be reviewed to ensure that the interests of consumers are not being compromised.
6. If we think that the level of funding has the impact of penalising current consumers, albeit that this may be for the benefit of future consumers, we may choose to defer some of the funding of the proposed contributions until future price control reviews. This is to ensure that the overall interests of consumers are met.
7. Subject to any applicable incentive mechanism, we retain the right to disallow recovery of any increase in pension costs, which has the effect (intentional or otherwise) of reducing other operating costs on a symmetric basis, and therefore where the application of the over-funding principle would not be consistent with Principle 2 (Attributable Regulated Fraction).
8. Subject to any applicable incentive mechanism, we would not recover from companies reductions in cash pension contributions which can be shown to be as a direct result of increased efficiency in employment management costs, for example as a result of outsourcing or moving staff from a current defined benefit to a lower-cost defined benefit or a defined contribution scheme. This does not apply to DPCR5, because there are specific sharing factors.
9. Subject to any applicable incentive mechanism, the difference between the ex ante allowances for pension administration costs and the PPF levy and the actual cash funding costs will be adjusted at the next price control. This will be subject to DNOs demonstrating that the costs are economic and efficient, e.g. that steps have been

taken to mitigate, in particular, the risk-based element of the PPF levy and are comparable with appropriate comparators.

- 10.** As noted under Principle two, we will apply a revised regulatory fraction where there have been structural changes to a scheme in the price control period on a case-by-case basis. The element of the fraction related to movements in unfunded ERDCs will only be changed at a subsequent price control, except where through structural changes it can be clearly demonstrated that they have been fully funded.
- 11.** Subject to any applicable incentive mechanism, increases in pension costs against allowances will therefore in general be recoverable from (or decreases recaptured for) consumers on an NPV-neutral basis.

Unexpected lump sum deficit payments

1.29. These tend to occur in instances of change in corporate control, or through corporate activity within the NWO's wider group. Whilst one can understand the trustees taking the opportunity to repair the deficit faster, it is not clear why consumers should pay an accelerated profile.

1.30. We will review the payment of the lump sum compared to what the position would have been if the deficit had been spread over a number of years. This is to ensure that consumers have either positively benefited from, or have not been disadvantaged by the accelerated funding. Where a company cannot satisfy us that the accelerated payment has been in the interests of customers (as opposed to shareholders or scheme members), we will treat the payment as having been made over the period according to the original deficit recovery plan.

Principle 6 - Severance - Early Retirement Deficiency Contributions

Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

1.31. Since 31 March 2004, Early Retirement Deficiency Contributions (ERDCs) whether fully funded, partially funded or totally unfunded, are a matter solely for shareholders.

1.32. The principle requires an adjustment to be made to the allowances for future price controls to exclude the impact of ERDCs resulting from redundancy and re-organisation, which have been offset by use of surpluses, rather than being funded by increased contributions.

1.33. This provides for consistent treatment with other restructuring and rationalisation costs. For this purpose, it will be necessary to roll forward the amounts of unfunded

ERDCs arising in each year of a previous price control period using the following methodology:

- At each control, companies will have supplied details of amounts relating to ERDCs. An adjustment is made to the Regulatory Fraction to reduce the deficit funding. Meaning the shareholders would in effect need to make good the shortfall.
- These unfunded ERDCs theoretically still exist at the next control 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.
- To derive the movements and obtain an updated position at the next control:
 - We take the position at the last control, rebased using RPI to real prices.
 - An adjustment is then made for companies where the scheme deficit has been cleared, by for example a take-over and subsequent funding in total of the deficit.
- This revised sum is then rolled forward each year to create a closing forecast position at the end of the last price control by:
 - adding expected returns (using the cost of capital for that control).
 - deducting the proportion of the deficit payments that were disallowed in that control. The expected return is used (rather than actual returns) since this is the figure on which the original valuation was based.
- The resulting forecast values of ERDCs at the end of the control period are compared to the deficits that are being forecast at the end of the control 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	23.4	22.0	20.4	18.6
Return at cost of capital	1.4	1.3	1.2	1.1	1.0
Deficit Payments (ERDC fraction)	(3.0)	(2.7)	(2.9)	(2.9)	(2.9)
C fwd	23.4	22.0	20.4	18.6	16.8
Deficit Payments (distribution element)	(20.0)	(18.0)	(19.0)	(19.0)	(19.0)
% of deficit reduced for ERDCs in DPCR4	15%				

Defined Contribution Pension Schemes

1.34. The above principles are particularly relevant to DB scheme costs. Benchmarking will include DC schemes, as will any true-up or sharing of under/over expenditure against ex ante allowances. As we do not assess DC scheme costs by reference to the scheme itself, in practice we do not have to consider Principle 2 (i.e. such non-regulated business costs are automatically excluded by the way we assess costs generally). Since DC contribution rates are not directly driven by actuarial assumptions or investment performance, Principles 3 and 4 are not applicable. Since deficits do not arise on DC schemes, nor do contribution rates have to rise as a result of actuarial assumptions, we do not have to consider under/over recovery.

Appendix 3 – A guide to Return on Regulatory Equity

1.35. Historically, the debate during a price control review has focused heavily on the level of the allowed return, even within a relatively narrow range. It is understandable that this number is of interest, particularly among analysts, as it constitutes a significant element of the overall revenue cap for regulated companies. Furthermore, it is a single figure rather than a complex incentive mechanism and its outperformance can be readily demonstrated in the capital markets.

1.36. However, we believe that an excessive focus on the allowed return means that the impact of other elements of the price control can be overlooked even though they are potentially of a greater magnitude. We have therefore developed a tool to holistically measure the performance of the companies under the control – by measuring returns on regulatory equity over the five year period.

1.37. When calculating RoRE, we are not attempting to be consistent with accounting return on equity metrics. We do, however, think it is important that companies, investors, analysts and other interested parties understand the basis of our calculations and also why actual shareholder returns differ from those presented in our analysis. We do not, for example, take account of a company's capital structure nor analyse the cost of its embedded debt, both of which would likely impact actual returns. Furthermore, we have only made adjustments for what we consider to be meaningful variances from an assumed baseline. We recognise that there may be other factors that can affect actual shareholder returns. In our analysis we consider variances in returns from: cost expenditure, pensions, tax, incentives and the cost of debt. For the latter, we measure the difference between our allowance and a benchmark based on actual 10 year trailing average bond yields for a comfortable investment grade issuer. This allows a like for like comparison between DNOs.

1.38. When measuring RoRE, we initially calculate a value for the equity component of the Regulatory Asset Value (RAV) by applying our notional gearing assumption, i.e. 57.5 per cent in DPCR4 and 65 per cent in DPCR5. Secondly, the starting point is always the allowed return on equity implied within the cost of capital determination for the price control, i.e. 7.5 per cent in DPCR4 or 6.7 per cent in DPCR5. We then express variances between out-turned expenditure versus our ex ante determinations as a percentage of the equity capital for each relevant driver. These are then added or subtracted from the baseline equity return. In calculating the RoRE we apply any necessary adjustments, for example – corporation tax and for variances in total expenditure, the relevant IQI incentive rate.

1.39. A simple version of our RoRE calculation is shown in the table below. In our full analysis, the calculations are more detailed. However, for the purposes of the demonstration the results in this simple version are broadly representative.

Example:

	Company	
	A	B
RAV (£m)	1000	1000
Gearing	65%	65%
Equity portion of RAV (£m)	350	350
Driver 1: Cost performance		
Cost allowance (£m)	100	100
Out-turned spend (£m)	95	110
Delta (pre-IQI)	5	-10
IQI incentive rate	50%	50%
Delta (post-IQI) (pre-tax)	3	-5
Additional returns (after tax)	2	-4
RoRE effect (costs)	0.5%	-1.0%
Driver 2: Incentives		
Return from incentives (£m, pre-tax)	-5	15
Return from incentives (£m, post-tax)	-3.6	10.8
RoRE effect (incentives)	-1.0%	3.1%
Driver 3: Cost of debt		
Cost of debt allowed in WACC	3.6%	3.6%
Cost of debt achieved	4.0%	4.0%
RoRE effect (debt)	-0.7%	-0.7%
Allowed return on equity	6.7%	6.7%
Sum of RoRE effects	-1.2%	1.4%
Achieved RoRE	5.5%	8.1%

Appendix 4 – The Authority's Powers and Duties

1.40. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.41. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.¹⁸

1.42. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly¹⁹.

1.43. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.44. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them;²⁰
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.²¹

¹⁸ Entitled "Gas Supply" and "Electricity Supply" respectively.

¹⁹ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

²⁰ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

²¹ The Authority may have regard to other descriptions of consumers.

1.45. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed²² under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

1.46. In carrying out the functions referred to, the Authority must also have regard, to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.47. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation²³ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

²² or persons authorised by exemptions to carry on any activity.

²³ Council Regulation (EC) 1/2003

Appendix 5 - Glossary

123

132 kV

Only covers assets at the 132 kV voltage level.

B

Business Support Costs (BSCs)

Consists of the following activities: IT & Telecoms, Property Management, HR & Non-Operational Training, Finance and regulation and CEO etc. The definitions of these activities can be found within the DPCR5 August Forecast Business Plan Questionnaire Rules.

C

Capital Expenditure (Capex)

Expenditure on investment in long-lived distribution assets, such as underground cables, overhead electricity lines and substations.

D

Distribution Connection and Use of System Agreement (DCUSA)

The Distribution Connection and Use of System Agreement (DCUSA) was established in October 2006 as a multi-party contract between the licensed electricity distributors, suppliers and generators of Great Britain. It is concerned with the use of the electricity distribution systems to transport electricity to or from connections to them.

Distribution Network Operators (DNOs)

A DNO is a company which operates the electricity distribution network which includes all parts of the network from 132kV down to 230V in England and Wales. In Scotland 132kV is considered to be a part of transmission rather than distribution so their operation is not included in the DNOs' activities.

There are 14 DNOs in the UK which are owned by seven different groups.

Distribution Price Control Review 4 (DPCR4)

Distribution price control review 4. This price control runs from 1 April 2005 until 31 March 2010.

Distribution Price Control Review 5 (DPCR5)

Distribution price control review 5. This price control is expected to run from 1 April 2010 until 31 March 2015.

Diversions expenditure

Expenditure associated with the diversions of OHLs as the result of wayleave terminations which are not rechargeable. Also includes expenditure on the conversion of wayleaves to easements, injurious affection and related costs.

E

Early Retirement Deficiency Contributions (ERDCs)

Cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

Equity risk premium (ERP)

The Equity Risk Premium (ERP) measures the additional return required by investors to compensate them for the risk of holding equities over and above the risk-free rate.

Ex ante

Refers to a value or parameter set down before the commencement of the price control period.

Ex post

Refers to a value or parameter ascertained after the commencement of the price control period.

Extra High Voltage (EHV)

Includes all voltage levels above 20kV up to but excluding 132kV.

F

Fast money/fast pot

Fast money is the revenue that is matched to the year of expenditure. Fast pot costs are those which are recovered through fast money.

Forecast business plan questionnaire (FBPQ)

A major information request by Ofgem in the form of excel spreadsheets and associated narrative guidance. This captures key historical information and forecast information for the remainder of DPCR4 and DPCR5. We also obtained detailed explanatory narratives from each DNO.

G

Gas distribution networks (GDNs)

GDNs transport gas from the National Transmission System to final consumers and to connected system exit points. There are currently eight GDNs in Great Britain which comprise twelve local distribution zones.

Gas Distribution Price Control Review (GDPCR)

The review of the price control applying to gas distribution networks. The review extended the existing price control for the year 2007-08 and reset the control for the period commencing 1 April 2008.

General reinforcement expenditure

Investment to reinforce the network due to changes in general demand or generation background that is not directly attributable to a specific demand or generation connection.

Gigawatt (GW)

A measure of energy equal to one thousand megawatts.

H

Her Majesty's Revenue and Customs (HMRC)

High Voltage (HV)

Includes all voltage levels above 1kV up to and including 20kV.

I

International financial reporting standards (IFRS)

A set of rules stating how financial statements are to be prepared. IFRS are intended to be applied globally though some companies still report under their own national rules.

Index linked gilt (ILG)

A UK government bond the dividend of which is raised in line with some index (typically the RPI). The capital repaid at the end is also adjusted in line with the reference index.

Independent distribution network operators (IDNOs)

Any electricity distributor whose licences were granted after 1 October 2001. IDNOs do not have distribution services areas.

Information Quality Incentive (IQI)

The IQI is a mechanism for setting price control allowances that provides ex ante incentives for DNOs to submit accurate forecasts of their expected expenditure and provides incentives for efficiency improvements once the price control has been set.

Investment grade credit rating

For the purposes of the initial proposals means a rating at or above the levels shown below:

- Standard & Poor 's Ratings Group BBB-
- Moody's Investors Service Inc Baa3
- Fitch ratings Ltd BBB-

K

Kilowatt (KW)

A measure of energy equal to one thousand watts.

L

Low Voltage (LV)

All voltage levels up to and including 1kV.

M

Megawatt (MW)

A measure of energy equal to one thousand Kilowatts.

N

Net present value (NPV)

Net present value is the discounted sum of future cash flows, whether positive or negative, minus any initial investment.

Net present value (NPV) neutral

Alternative revenue profiles are net present value neutral if they have the same NPV. We usually use this term in the context of spreading revenues over time (i.e. a price control period) where the costs that they represent have already been incurred, or in comparing different profiles of allowed revenue.

Network Operating Costs (NOCs)

Consists of the activities of Faults, Inspections and Maintenance and Tree Cutting. The definitions of these activities can be found within the DPCR5 August Forecast Business Plan Questionnaire Rules.

Network Operators (NWOs)

Companies which own and operate the gas and electricity networks in Great Britain. This includes DNOs, GDNs and TOs.

P

Pass through (of costs)

Costs for which companies can vary their annual revenue in line with the actual cost, either because they are outside the DNO's control or because they have been subject to separate price control measures.

Pension protection fund (PPF)

The Pension Protection Fund was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

R

Rating agencies

The principle rating agencies that Ofgem uses are:

- Moodys
- Fitch
- Standards & Poor's

Reactive power

The difference between apparent power and useful power.

Regulatory asset value (RAV)

The value ascribed by Ofgem to the capital employed in the licensee's regulated distribution or (as the case may be) transmission business (the 'regulated asset base'). The RAV is calculated by summing an estimate of the initial market value of each licensee's regulated asset base at privatisation and all subsequent allowed additions to it at historical cost, and deducting annual depreciation amounts calculated in accordance with established regulatory methods. These vary between classes of licensee. A deduction is also made in certain cases to reflect the value realised from the disposal of assets comprised in the regulatory asset base. The RAV is indexed to RPI in order to allow for the effects of inflation on the licensee's capital stock. The revenues licensees are allowed to earn under their price controls include allowances for the regulatory depreciation and also for the return investors are estimated to require to provide the capital.

Regulatory reporting pack (RRP)

The price control review information submitted annually to Ofgem under standard licence condition 52 in accordance with (and in the form and content prescribed by) the price control review reporting rules.

Return on Regulated Equity (RORE)

The financial return achieved by shareholders in a licensee during a price control period from its out-turn performance under the price control. The return is measured using income and cost definitions contained in the price control regime (as opposed to accounting conventions) and is expressed as a percentage of (share) equity in the business. Importantly, in the calculation the gearing (proportions of share equity and debt financing in the RAV) and cost of debt figures used are those given as the 'assumed' levels in the relevant price control final proposals. The aim of the RORE measure is to provide an indication of the return achieved by the owners of a licensee which can be compared to the cost of equity originally allowed in the price control settlement and to the return achieved by other licensees on an equivalent basis.

Reporting Instructions and Guidance (Rigs)

A document that is published as part of the price control settlement which sets out further detail on how the price control is to be implemented and how compliance with it will be monitored.

RPI-X@20

RPI-X@20 is our root and branch review of regulation following 20 years of regulation under the RPI-X approach whereby allowances are pegged to a certain amount below RPI inflation.

RPI-X

The form of price control currently applied to network monopolies. Each company is given a revenue allowance in the first year of each control period. The price control then specifies that in each subsequent year the allowance will move by 'X' per cent in real terms.

S

Slow money

Slow money is where cost costs are added to the RAV and revenues allow recovery of the costs over time (currently 20 years) together with the cost of financing this expenditure in the interim.

T

The Pensions Regulator (TPR)

The pensions regulator is the UK regulator of work-based pension schemes.

Totex

The aggregate net network investment, net network operating costs and indirect costs, less the cash proceeds of sale of assets and scrap.

Transmission Operators (TOs)

The companies which own and operate the gas and electricity transmission networks in Great Britain.

Transmission exit charges

The charge levied by TOs on DNOs in respect of the cost of assets provided at the interface between the transmission and distribution networks.

Transmission Price Control Review (TPCR)

The TPCR will establish the price controls for the transmission licensees which will take effect in April 2007 for a 5-year period. The review applies to the three electricity transmission licensees, National Grid Electricity Transmission, Scottish Power Transmission Limited, Scottish Hydro-Electric Transmission Limited and to the licensed gas transporter responsible for the gas transmission system, NGG.

Triennial valuation (pensions)

A detailed actuarial review of a pension scheme's assets in comparison to its liabilities in present value terms. It is used to determine ongoing contributions and any deficit recovery plan.

Trigger

A mechanism to re-set allowed revenue levels when certain criteria are satisfied – intended to address uncertainties present when allowances are initially set

U

Use of System charges (UoS)

Charges paid by generators and demand customers, usually via suppliers, for the use of the distribution network.

V

Vanilla WACC

The weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity. In our financial modelling, it is the figure we use to calculate the cash return on the RAV.

VIX index

Chicago Board Options Exchange Volatility Index, a popular measure of implied volatility with high values implying pessimism and low values implying optimism.

W

Wheeling charges

Charges in respect of units of energy which pass through a DNO's network.

Weighted Average Cost of Capital (WACC)

This is the weighted average of the expected cost of equity and the expected cost of debt.

Appendix 6 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report? Was the report easy to read and understand, could it have been better written?
3. To what extent did the report's conclusions provide a balanced view?
4. To what extent did the report make reasoned recommendations for improvement? Please add any further comments?

1.2. Please send your comments to:

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