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Mr Cemil Altin
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Our ref	*Your ref*	*Date*
474 / 485		26 August 2003

Dear Cemil

Western Power Distribution's Response to:-
(i) Developing Monopoly Price Controls - Initial Conclusions
(ii) Electricity Distribution Price Control - Initial Consultation

I am responding to the above papers on behalf of Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc.

Please note our response to the DPCR initial consultation should be read in conjunction with our response to the Monopoly Price Control Initial Conclusions, particularly in respect of the financial and pensions issues as well as our responses to the consultation following the reports from Frontier Economics.

I trust that our response is helpful. Please do not hesitate to contact me if you require any further information or wish to meet to discuss our response.

Yours sincerely

R G WESTLAKE
Regulatory & Government Affairs Manager

Distribution Price Control Review - Initial Consultation – July 2003

Western Power Distribution's Response

Chapter 2 Background

- *DNOs Performance under existing price controls*

We note the analysis that shows on average DNOs, in 2001/2, were outperforming the operating costs assumptions by 22%, demonstrating that incentive based regulation is successful. It is important to recognise that because significant costs have already been removed from DNOs cost bases further significant cost reductions cannot be achieved without compromising standards of performance.

Chapter 3 Form, Structure and Scope of the price controls

Para 3.29 Views are invited on any of the issues raised in this Chapter and particularly on:

- *the structure of the price controls;*

WPD supports the RPI-X mechanism that has served customers well since 1990 and provided incentives for companies to out-perform. We support pass-through for those costs that are outside the direct control of the DNO.

- *the treatment of the revenue driver;*

The 50/50 revenue driver strikes a reasonable balance between protecting against perverse incentives to increase units distributed whilst providing a degree of financial incentive to companies to respond to the demands of customers.

- *the scope of the price controls and the treatment of the various categories of excluded service revenue;*

We support continuation of the treatment of excluded services revenue for all categories of activities supplied at the customer's request listed in the document with the exception of EHV charges. Whilst EHV charges often have individual supply requirements this does not preclude them from being placed within the revenue cap. This will afford the same protection for these customers as exists for all other price controlled customers and will provide a degree of certainty in the forecast of these costs over the period of the price control. Including EHV charges within the price control will allow rebalancing to take place where the costs have moved.

Alternatively if EHV charges remain excluded, the price setting cash flow methodology will need to recognise the very significant reduction in EHV units that

is likely to arise in South Wales. Over the last 3 years EHV consumption has decreased by 14% and we see this trend both continuing and accelerating.

- *the duration of the price control; and*

We support the continuation of 5 year price control periods.

- *the incentive framework applying to DNOs and improvements that could be made to the framework including ensuring that the best performers are provided with appropriate incentives to continue to improve.*

WPD supports the rolling RAV adjustment and the method put forward by the DNOs as well as rolling adjustments for operating costs and the equalisation of incentives for operating and capital costs.

It is essential that all companies, including the best performing ones are rewarded to perform and that cost and performance are benchmarked together.

Chapter 4 Quality of service and other outputs

Para 4.46 Views are invited on any of the issues raised in this Chapter and in particular on:

- *the scope of output measures;*

We note the consideration being given to extending output measures to include environmental and social performance. In considering this Ofgem will need to take account of companies ability to both measure and achieve any such performance targets and specifically recognise and allow for the costs of such activities. WPD supports Ofgems' use of RIAs and this is particularly pertinent in respect of the introduction of environmental and social measures.

We support the general principle of disaggregation of performance using ranges of values for factors such as the percentage of overhead line and circuit length.

- *how frontier performance could be rewarded;*

We note that Ofgem intend to publish initial proposals on this in October and look forward to commenting further at that time.

- *the treatment of GOSPs including their scope;*

In respect of the customer research, the objective of Stage 1 is to identify the general preferences of customers in relation to the services provided by their DNO. Our view is that it is important that this is done without a steer as a robust survey should not start from the assumption that it knows the issues important to customers or try to lead them. We suggest that to ask specific questions on undergrounding of networks, embedded generation or the impact of street works is inappropriate at this

point. The questions should be open and the survey team should interpret and group responses as appropriate.

- *the treatment of exceptional events, including possible interim steps that could be introduced; and*

We would support the removal of the severe weather exemption and introduction of automatic payments on the basis that companies are made financially whole.

In our view there should be a clear separation between compensation payments to customers and reward/penalties during storm conditions. The basic principle being that customers are compensated with the minimum of fuss as near to the event as possible and that performance rewards/penalties are dealt with by a separate process on a considered basis.

In respect of rewards/penalties for storm performance then for each event an assessment of performance should be made in certain key areas, call centre performance, staff mobilisation, restoration times, customer correspondence/claims etc . The average performance for each company weighted by customer numbers (ie weighting by severity) over a 12 month period would then determine any reward or penalty to be applied in the following year.

Already under IIP exemption claims, companies are required to supply information relating to some of the above factors and the onus should be on them to supply additional information to OFGEM in a format that allows the determination of reward or penalty.

We note that Ofgem intend to consult separately on this shortly and look forward to discussing these principles in detail at that time.

- *incentives for the speed and quality of telephone response.*

We support the aims of the recent paper published on quality and speed of telephone response and will respond separately particularly in respect of how the information reported by companies is factored into these measures.

We support changes to the monthly survey to reflect customer's views on automated messages. This will enable OFGEM to make valid comparisons between companies with differing telephony systems.

Chapter 5 Distributed generation

Para 5.48 Views are invited on any aspects of the issues raised in this chapter and in particular on:

- *whether there are other incentive mechanisms or arrangements not discussed in this chapter that would provide better protection for consumers and more appropriate incentives to DNOs;*

We have not identified mechanisms other than those discussed in the paper (or varying hybrids of them).

- *whether the hybrid mechanism provides an appropriate balance of incentives and if so, how the mix between pass-through and an incentive rate might be established;*

Our concerns with the hybrid mechanism suggested are:

- it is inappropriate to earn a lower rate of return on assets installed on the basis of information accepted in good faith at the time of connection if the connectee subsequently reduces their usage
- the method will encourage deferment of network reinforcement to the latest possible time to give the maximum certainty that the generation is connected
- with a differential return, there will be disputes over the split of investment between that needed for generator connections and that for other purposes

Whilst having more risks in the period of the price control, we believe that a £/MW driver (possibly differentiated into 'baskets') with logging-up of assets to enter the RAB at subsequent price reviews represents a more stable long term investment environment. The issue of an 'efficiency test' for any stranded assets is the same issue that applied to existing reinforcement investment that is assessed as part of the price control.

- *whether a "network availability" measure can be established and utilised in practice;*

As most distributed generation will continue to be connected to radial networks for some time, the easiest way to assess network availability is by measuring the availability (and energisation) of the connection point to the network.

- *whether the additional arrangements for Registered Power Zones and funding of innovation provide significant improvements and how the costs could be separately identified in practice; and*

We doubt that the RPZ and IFI will result in a significant improvement to the amount of generation connected to networks, however they will provide a route for new ideas to be trailed and evaluated

- *whether a separate mechanism is needed to deal with potential risks of stranded costs falling on demand consumers, for example to transfer costs between the consumers of different DNOs.*

We do not believe that a mechanism to transfer costs between consumers of different DNOs is appropriate. If such a mechanism is thought to be desirable, it would be more transparent, and auditable, to retain deep connection charges and raise a levy on all customers that could be used as a central fund to pay for deep connection charges. This would enable the lowest cost solutions to be adopted first on a national basis.

Chapter 6. Assessing costs

Para 6.64 Views are invited on any of the issues raised in this Chapter and in particular on:

- *the approach to assessing companies efficiency and their forward costs – both opex and capex, including:*
- *the use of bottom up and top down modelling*
- *improvements that could be made to the approach taken at the last price control review;*

Capex:

In assessing capex needs, bottom up modelling is essential to recognise the differing mix of assets, asset conditions and differing load growths between distributors.

Opex:

Efficiency is not the same as lowest cost, and in setting opex targets these should be set in the context of each network and linked to performance targets – i.e. a particular level of cost for a particular level of performance for a particular network configuration.

In the past, in the absence of known operating costs drivers for distribution businesses, linear regression has been attempted in order to determine an approximate/proxy "efficient frontier". However, regression is not useful if conducted on the basis of DPCR3 because it is based on the assumption that costs are largely driven by customer numbers, without understanding of what the cost causation in DNOs is.

Once a causal cost analysis is available, regression is no longer a primary comparative tool for all costs.

A bottom up approach should use actual cost drivers and should apply irrespective of business structure, operate analogously to IIP by taking into account performance.

DNOs operate relatively simple businesses. The activities undertaken can be summarised as:

- **Fieldwork**: people climbing poles and digging holes to repair, maintain, extend and renew network components
- **IT/Comms**: operating systems in order to schedule and control the network, fieldwork and corporate systems
- **End-user customer interactions**: maintaining a call centre to deal with faults, new connections
- **Overheads**: DNOs run as businesses incurring costs as necessary in order to comply with laws, regulations and best practise, as well as the costs of the activity involved in financing operations.

Each of these activities have different cost drivers, and in comparing companies each cost should be compared using its own driver in order to avoid degrading the usefulness of the comparison. Opex fieldwork consists of the maintenance of assets – it is therefore not surprising that the more assets there are to maintain the more it should cost, subject to the age, disposition and geography of those assets. The costs of other activities are either fixed or have their own drivers. However for the other costs, capitalisation policy may distort the comparison and to avoid the distortion the costs should be compared on a total cost basis.

This approach does not rule out the use of regression to compare, in particular, fieldwork costs included in opex; it does however require the role of regression to change from being an attempt at a discovery of cost drivers for total opex, to being a comparison of efficiency given an expected level of performance and knowledge of what the cost drivers for a DNO are. As a pro-forma of how costs are driven, WPD believes that using the activities set out above, costs are caused approximately as follows:

	Cost and % of Total Opex	% of Total Asset Driven	% of Total Customer Driven	% of Total Fixed
Fieldwork	78%	73%	-	5%**
IT/Comms	9%	4%	-	5%
End-user interaction	2%	1%	1%	-
Corporate	11%	1%	1%	9%
Total	100%	78%	2%	19%

** Almost entirely premises cost

Once the cost drivers are better understood it is possible to strike the balance between the cost of fieldwork cost and network performance as being the balance between fieldwork cost per km of network as against the normalised benchmark system performance.

- *the use of the asset risk management survey;*

In updating the ARM survey for 2003/04, it is important that the survey encompasses the 'value for money' issue as well as the link to outputs.

- *how companies' own cost projections should be reviewed.*

We welcome discussion on how our capital projections are formulated to help Ofgem understand the basis on which they are prepared.

Chapter 7 Financial issues

Para 7.19 Ofgem would like to hear views on any of the issues raised in this Chapter and in particular on:

- *any changes that should be made to the financial ringfence and the implication of the introduction of a special administration regime;*

WPD supports the introduction of a special administration scheme as well as a clear statement of at what leverage of a DNO Ofgem would seek to take action, and why.

- *the treatment of pension costs.*

Pension costs are either a staff-related cost or otherwise arise as a result of events without DNOs control. To the extent that staff costs include pension costs for those staff, they are already dealt with within the assessment of efficient opex. To the extent that additional pension costs arise as a result of events beyond DNOs control since both DPCR3 and the last actuarial valuation (eg stock market movements) they should be allowed as a pass-through cost as a result of being a cost that is not controllable, but is separable.

Developing network monopoly price controls - Initial conclusions – June 2003

Western Power Distribution's Response

Chapter 2 General principles for price control regulation and consistency of regulatory frameworks

Para 2.32 Ofgem would welcome views on any of the issues raised in this Chapter and in particular on:

- *the general principles of price control regulation;*
- *the level of consistency in regulatory frameworks;*
- *Ofgem's proposal to roll forward the Scottish Transmission price controls to align the timing of the full review with the transmission owner price control review in England and Wales; and*
- *whether it would be appropriate to increase the level of harmonisation in review dates between electricity transmission and gas transportation, and if so, how this should be achieved.*

Para 2.22 We agree that it is not appropriate to introduce fundamental changes to the distribution regulatory framework at this price control review to bring it more in line with Transmission.

Chapter 3 Assessing costs and incentives

Para 3.58 Ofgem would welcome views on any of the issues raised in this Chapter and in particular on:

- *the retention period for efficiency savings;*
- *the most appropriate way of dealing with uncertainty and new obligations and costs; and*
- *incentives to invest*.

para 3.15 : we welcome that Ofgem intends to allow companies to retain the benefits of all capex efficiencies for five years regardless of how they have been achieved. In practice to make a distinction between capex efficiency savings due to lower cost delivery of a project and project deferment is difficult to determine.

para 3.28 : we support Ofgem in improving the Regulatory Accounting Guideline (RAGs), which will improve reporting transparency

para 3.34 WPD supports the paper submitted to Ofgem by Unitied Utilites on behalf of the Electricity Association. Whilst 50/50 is not necessarily always the right answer it has to be a good approximation for the optimal point.

Para 3.3.8 WPD supports the use of benchmarking, provided that the benchmarking takes into account the causes of cost and also the levels of performance expected

from particular networks configurations for that level of cost and believes this does enhance incentive properties.

para 3.44 : we welcome Ofgem's intention that non-operational capex be included in the RAV

para 3.51 We believe there would be merit in moving to a formal logging up process to deal with costs that are not material enough in themselves to warrant a reopening of the price control. As DNOs have removed significant amounts of cost, scope for further reduction are severely limited and therefore a DNOs ability to absorb cost increases severely impacted.

para 3.57 We support OFGEMs view that a better understanding of DNOs future investment needs modeling will be beneficial. We support the drive to identify and quantify investment drivers in the price control formulae.

It is highly unlikely that companies will deliberately over-spend on their capex allowances because the commercial reality of shareholder interests will act as a strong buffer against over-excessive cash outlays. We therefore consider it to be inappropriate to penalise companies with a lower rate of return on such over investment.

Chapter 4 Financial issues

Para 4.36 Ofgem would like to hear views on any of the issues raised in this Chapter and in particular on:

- *any changes that should be made to the financial ringfence and the implication of the introduction of a special administration regime;*
- *the approach to the cost of capital including the treatment of tax costs; and*
- *the treatment of pension costs.*

Please refer to our response to Chapter 7 of the DPCR initial consultation.