

**SP Energy Networks Response to Electricity Distribution Price Control Review  
(Initial Consultation May 2008) - Introduction and Overview**

**SP Distribution and SP Manweb (SP Energy Networks)**

**Response to Electricity Distribution Price Control Review  
(Initial Consultation May 2008)**

**23<sup>rd</sup> June 2008**

**Introduction and Overview**

# **SP Energy Networks Response to Electricity Distribution Price Control Review (Initial Consultation May 2008) - Introduction and Overview**

## **Introduction and Overview**

We welcome the opportunity to respond to Ofgem's Electricity Price Control Review, Initial consultation document.

Distribution Network Operators (DNO) have a central role to play in the delivery of energy policy objectives in both a European and UK context. Delivery of these objectives will require different behaviours from network companies together with a balanced, supportive and forward looking regulatory framework.

We are therefore enthusiastic about the open nature of the initial consultation document, with its strong emphasis on environment and customers. If we are to achieve the objectives set out in the paper, we will need to consider a more coordinated approach to developing a regulatory framework across our industry and the framework that we develop must be flexible enough to facilitate and stimulate companies' abilities to meet these objectives.

For SP Energy Networks, the key challenges that this Review must address can be summarised as follows:

- Implementing a workable and balanced set of incentives aligned with energy policy objectives;
- Developing an effective and equitable framework that is in the interests of the end customer
- Investing to preserve the safety and continuity of energy supplies and ensure that networks are sufficiently resilient to severe weather events;
- Ensuring that electricity network companies are able to continue to attract investment against a background where successive price reviews have significantly increased the risk borne by DNOs;

We are committed to working in partnership with Ofgem, government, the industry and all other stakeholders to meet these challenges.

The initial consultation would seem to suggest the promise that this price control review can represent a major step forward on the part of Ofgem and the companies towards building an UK electricity infrastructure that is robust enough to cope with the challenges ahead and that will act as a catalyst towards reform in other regulatory and legal processes, for example planning. This forthcoming price control review is therefore of fundamental importance to our energy future.

We now consider the key objectives and themes raised in Ofgem's overview in chapter 1 before turning to detailed responses to the questions outlined by Ofgem in subsequent chapters.

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**1 Environmental issues - implementing a workable and balanced set of incentives aligned with energy policy objectives**

**1.1 Losses**

*DNOs have a significant role to play in reducing green house gas (GHG) emissions, however the DPCR4 losses incentive mechanism does not facilitate this role and requires to be replaced with a 'quasi outputs' based approach.*

Ofgem have correctly identified network technical losses as the single most important area in terms of carbon footprint for DNOs, particularly as our industry moves into a period of continued and intense asset replacement.

While we believe that there is a material opportunity to achieve a reduction in GHG, the current mechanism does not provide the appropriate framework to achieve this because it does not provide adequate signals to DNOs to invest in either low loss technology or loss reducing initiatives, it does not extend to deal with other market participants such as IDNOs and it cannot be accurately observed and measured as an output because of underlying volatility in the Settlements system.

Evidence suggests that the existing mechanism has produced little by way of real underlying reductions in technical losses and would seem to provide poor value for consumers in its current form.

One further perverse consequence of the current regulatory mechanisms in relation to IDNOs is that this class of licensed distribution operator is incentivised to utilise higher loss equipment than an equivalent DNO would utilise.

We therefore propose a radical overhaul of the current mechanism and a move toward an agreed programme of initiatives and investment with targets based around an auditable, engineering based model of individual companies networks. We describe this mechanism further on as a "quasi outputs" measure. Applying this approach can provide much greater certainty of environmental benefits for customers in relation to technical loss reduction initiatives.

As a consequence of the volatility in EU carbon prices and the exchange rate of the Euro, the Industry and Ofgem will need to agree an appropriate economic value of avoided losses.

While we accept that this will require the Regulator to have a more active role in monitoring this type of mechanism and companies will require to invest significant effort reciprocally, we think the importance of the objective merits this approach and similar processes have already been established relatively successfully in the area of quality of service.

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### 1.2 Carbon footprint

*Beyond Losses we believe that DNOs should be monitoring the impact that their operations have on the environment as a matter of good corporate practice. However, the DNOs already interact with a host of regulatory bodies in these areas, including environmental agencies, and given the added complexities and a host of other factors that would need to be considered we believe any additional incentives in this area should be limited.*

Having already singled out network technical losses, which dominate the DNOs' carbon footprint, developments in the remaining areas should be limited and proportionate.

It is clearly desirable that all companies think progressively about the direct and indirect impact that they have on the environment. SP Energy Networks has a long track record in monitoring such factors as the impact of our use of transport and hazardous materials, to name a couple of examples, within our Corporate Social Responsibility activities. Experience has shown that setting environmental measures and incentives is complicated by company structures, the level of outsourcing deployed, different company policies and objectives, the franchise areas and environment served by businesses, network design and distribution asset characteristics and a host of other factors.

It would therefore seem to be a challenging objective for Ofgem to establish a baseline for all companies on an individual basis together with the development of a practicable incentive mechanism that is equitable to all. It also seems that perhaps Ofgem is stepping into the territory of other Regulatory bodies and we wonder if it is necessary.

An SF6 mechanism similar to TPCR4 could be developed fairly readily, however the scope for reduction and management of SF6 portfolio is much more limited on distribution networks.

As highlighted in paragraph 1.1 it would seem far more important, given the weight Ofgem attribute to the importance of Losses, that the Regulator concentrates efforts on developing a new Losses mechanism.

If there does remain a desire on the part of companies and the Regulator that carbon footprint is dealt with more generally, this measure should exclude Losses entirely (to be dealt with separately), and could be based on the existing Discretionary Reward mechanism for customer service where a relatively small reward is available to be shared among companies that demonstrate initiative.

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### 1.3 Distributed Generation Incentive Mechanism (DGIM)<sup>1</sup>

*We believe the existing principles of the DGIM are perfectly compatible with the objectives of connecting distributed generation and propose that the existing mechanism should continue with only minor modification to deal with areas where there is only sparse existing infrastructure.*

SP Energy Networks operates in two of the most resource rich areas for Renewable Generation in the whole of Great Britain. It is our view that the low levels of megawatts connected is directly attributable to the complexities of obtaining planning consents and land rights, and to the structure of incentives faced by the GB Transmission System Operator (TSO) under the current regime, and does not relate to the DGIM or the DG connections issues identified.

We are concerned that in Scotland we may not be permitted to connect schemes that cause no local transmission constraint costs, and whose impact on deeper transmission constraint costs appears to be theoretical rather than clearly demonstrated in practice.

To illustrate, we have a situation where a Distributed Generation scheme which could connect by 2010, may be forced to wait until 2016, at the earliest, even though the scheme requires no local transmission works and whose generation output would net off the local GSP demand at all times. In this case there is no incentive on the TSO to progress a solution to this problem as quickly or pragmatically as the customer or we would like. Indeed the TSO will compound this situation significantly if its proposed CUSC CAP<sup>2</sup> 167 is implemented as this will allow the TSO to block all generator connections of 1MW and above on the basis of deep network constraints.

In situations such as these we think there is a room for a different approach to be taken. For example a way forward might involve some form of independent arbitration where an independent hearing and decision can be taken that considers all relevant factors, and focuses on practical rather than theoretical impacts.

It is also important to appreciate that any increases in constraints due to connecting DG in southern Scotland are likely to be short term given the progress and focus on upgrading the main interconnected transmission system (e.g. upgrade of the Anglo-Scottish Interconnector).

Regarding the DGIM itself, experience has shown that the existing DGIM does not work in certain areas where there is little or no existing infrastructure to accommodate connection of Renewable Generation, particularly in Wales where the Welsh Assembly has laid out its TAN 8 proposals. That said the mechanism itself needs only minor adjustment to accommodate these situations and the mechanism's existing principles are perfectly compatible with the objectives of connecting Distributed Generation. We therefore propose that the existing mechanism should continue with minor modification.

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<sup>1</sup> SP Manweb have 1521 MW of generation connected at 132kV and below; SP Distribution have 657 MW of generation connected at 33kV and below;

<sup>2</sup> CUSC – Connection and Use of System Code; CAP – CUSC Amendment Proposal;

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### 1.4 Growth

*We agree that the current DPCR4 growth term should not feature in DPCR5 as it is incompatible with energy policy and the existing mechanism is fundamentally flawed.*

### 1.5 Under-grounding:

*The current mechanism for under-grounding overhead lines in Areas of Outstanding Natural Beauty (AONB) has been a resounding success in areas of key environmental sensitivity. We would like to see this mechanism confirmed and strengthened going forward.*

The AONB funding mechanism during DPCR4 is enabling us to successfully address a number of stakeholder visual amenity concerns within Snowdonia National Park, with one completed project in the Catel Curig area considered a particular success by all stakeholders. Experience during DPCR4 has indicated that the financial strength of the mechanism needs to be increased.

### 1.6 Alternatives to network reinforcement:

*Significant effort should be made by both Ofgem and the industry to develop regulatory mechanisms to facilitate and incentivise DNOs to interact with customers and generators to deliver alternatives to network reinforcement where economically and environmentally appropriate.*

We believe that Ofgem's RPI-X review should address some of the more radical issues related to the future role of DNOs in relation to economic signals, mechanisms and incentives to enable DNOs to deliver non-infrastructure solutions. However, DPCR5 provides an opportunity to begin to develop and apply solutions of this nature, for example through development of the RPZ mechanisms or similar to deal with a wider range of generation projects and demand management projects.

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**2 Customers - developing an effective and equitable framework that is in the interests of the end customer**

**2.1 Quality of Service**

*We believe the existing IIP customer service mechanisms are broadly correct and should be developed to resolve identified weaknesses rather than radically changed. Two key areas that need to be addressed include the wide variation on incentive rates which does not value customers equally and can be unfair for companies at or near the frontier as measured by Customer Interruptions.*

There is a wide variation in the incentive rates, in terms of £m/CI and £m/CML, applicable to each DNO under the quality of service incentive regime (see table 1 below). This variation results in a significant inequality between the values attributable to customers in different parts of the country for a given interruption. This arises because the amount of revenue exposed to the incentive regime for each DNO is calculated simply as a percentage of allowed revenue, rather than being related to the relevant revenue component or the nature of the customer base.

We can illustrate this point by analysing the impact of an incident interrupting 500 customers for 60 minutes (see table 1 below). The highest value per connected customer across all DNOs is more than ten times the lowest and there are significant variations between companies.

Table 1: Analysis of Impact of Incident Interrupting 500 Customers for 60 Minutes

DNO	CI Rate (£m/CI)	CML Rate (£m/CML)	Incident Value (£k)	Impact per connected customer (pence)
SHEPD	0.08	0.11	10	1.45
WPD South West	0.1	0.17	9	0.88
SPM	0.18	0.22	11	0.73
SPD	0.23	0.3	10	0.53
LPN	0.3	0.34	11	0.50
NEDL	0.1	0.14	6	0.38
WPD South Wales	0.07	0.12	5	0.32
UU	0.18	0.23	7	0.29
YEDL	0.14	0.18	6	0.25
SEPD	0.18	0.26	6	0.21
CN West	0.15	0.2	5	0.21
SPN	0.09	0.14	4	0.17
CN East	0.11	0.15	4	0.17
EPN	0.16	0.25	4	0.13
<b>Average</b>	<b>0.15</b>	<b>0.20</b>	<b>7.1</b>	<b>0.35</b>

We note that some companies have expressed concern that the standardisation of penalty/reward rates might increase their relative exposure to risk under the CI/CML mechanism however we believe that this can be agreed by maintaining an appropriate

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cap on the total level of exposure in terms of revenue, or reviewing the bandwidth applied to targets.

We believe that the incentive value per customer should be equalized across GB; An alternative midway solution might be to link the incentives to components of each DNO's allowance rather than total revenues. For CML this could be opex and correlate to the fact that Ofgem view improvement in this area as an opex solution.

### **2.2 Treatment of companies out-performing CI benchmark**

*We believe that SP Manweb, the frontier performing company in terms of customer interruptions (CI) at DPCR4; was disadvantaged relative to other companies in terms of scope for out-performance of its CI target and an extremely onerous customer minutes lost (CML) target. This had the effect of skewing the incentive towards a penalty regime for SP Manweb compared to a reward regime for DNOs with worse historic CI performance.*

SP Manweb's unique interconnected network has historically delivered frontier CI performance to its customers. This ageing network requires higher levels of expenditure relative to more conventional networks to maintain performance at current levels. This is an issue that was not considered by DPCR4 and should be addressed at DPCR5.

In terms of CML, the targets for SP Manweb and four other DNO's that were out-performing the CI benchmark at DPCR4 were based on their own CI performance together with upper quartile interruption duration. However, those companies that were under-performing relative to the benchmark had CML targets based on the benchmark together with upper quartile duration. As a result, the regime is more onerous for the DNOs that perform best in terms of CI. We believe that this anomaly should be addressed at DPCR5 and that the CML targets for all DNOs should be based on benchmark CI performance.

At this stage we do not see any requirement or justification for increasing the DNO exposure to quality of service incentives.

### **2.3 Treatment of exceptional events**

*Given changing weather patterns and evidence of increased risk to network businesses from climate change effects we believe the thresholds for exceptional events needs to be examined carefully and revised. Further, the existing mechanism needs to be refined to exclude certain events out-with the control of DNOs.*

We believe that the requirement for an exclusion mechanism for exceptional events from the Quality of Service incentive has increased as a consequence of the frequency and severity of extreme weather events experienced during DPCR4 and the increased

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severity of extreme weather events forecast going forward by the Meteorological Office<sup>3</sup>.

Further, the current Quality of Supply incentive mechanism makes no exclusion for a range of events that DNOs are obliged to comply with through the Grid Code and are wholly out with their control. We propose that a number of revisions are introduced to enable Ofgem to exclude such events from the incentive mechanism.

### **2.4 Compensation & Guaranteed Standards**

***The proposal to consider a reduction in the GS trigger for supply restoration from 18 to 12 hours will be problematic for DNOs to deliver as networks have not been designed to deliver this level of service, and without technological developments in fault finding and fault repair together with significant resource increases cannot be delivered.***

If Ofgem require the GS trigger to drop to 12 hours then customers will need to pay the cost of technology developments and resource increases.

We also believe there is no justification for moving toward providing compensation to business customers for consequential losses, as this is a risk that DNOs cannot manage and would require to be funded by customers.

Any increased GS incentive payment for business customers would require to be funded through increased UOS charges for business customers and we do not believe this would necessarily be a development customers would welcome.

### **2.5 Worst served customers:**

***Worst served customers were not addressed at DPCR4 and continue to be a concern, therefore we are happy to see that Ofgem propose to deal with this in DPCR5.***

The requirements to address worst served customers are unlikely to be uniform across all companies and we will require to examine the relative service faced by these customer groups compared to the cost to resolve any issues.

SP Energy Networks is currently taking a lead in developing a measure of worst served customers through the Quality of Supply working group and are developing a mechanism that could be adopted by the industry.

### **2.6 Connections**

***As a Group we are committed to competition in connections provided it is on a level playing field and that the end consumer genuinely benefits in terms of quality and value of service. We do not believe that competition in connections has yielded material benefits or savings for end consumers under the existing framework and think this is an area of activity that needs a fundamental review and overhaul.***

<sup>3</sup> Meteorological Office draft report 2008 – Impact of Climate Change on the UK Energy Industry

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SP Energy Networks has actively engaged in facilitating competition in connections within our franchise areas. We are able to point to a level of competition in both our franchise areas (SP Manweb and SP Distribution) that is consistent with the level of competition in independent gas connections.

Ofgems Annual Connections Review of 2006/7 showed an IDNO market share in SP Distribution area of c.10% based on physical connections made. In the same period Independent Distribution Network Operators (IDNOs) won in excess of 50% of the market based on connections contracted, and dominated projects with higher volume end customer connections (i.e. relatively lower cost / higher margin connections).

In the highly competitive environment in our areas our connections business is under pressure to provide a service increasingly under demand but which is also a customer service interface that was over looked by the Regulator at DPCR4. For example, the significant growth in IDNO quotes and connections, delivered during DCPR4, has required an increased number of expert technical and commercial resources to develop interface arrangements and deal with increasing frequency of IDNO queries in this regard.

We are also concerned by the inequities that exist in the current regulatory framework where provision of licensed connections must be carried out at cost, failing to recompense shareholders for the significant opportunity cost entailed in the physical resources and working capital deployed.

### **2.6.1 Recent investigations**

Our two licensees have been the subject of a number of regulatory investigations aimed at directly reviewing how we interact with customers. One of the investigations paved the way for the adoption of standards for reporting timescales for provision of Point of Connection Quotations (POC) across the Industry.

In the most recent investigation we provided evidence relating to some 1750 point of connection quotations over a 9-month period. The investigation ultimately concluded that there was no evidence of any discriminatory behaviour by SPD and in their closure statement Ofgem drew a further significant conclusion that: *the level of connections activity in the SPD area was sufficient not to merit a general competition review.*

This conclusion raises a number of questions, relating to:

- Ofgem's veto regarding any DNOs ability to obtain a return on the activity of provision of connections in a demonstrably competitive environment
- need to consider how best to facilitate fair competition with IDNOs
- further consideration of proposals to extend competitive activities
- regulatory treatment of related parties who operate in a competitive market

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### **2.6.2 Charging arrangements**

We recognise that existing charging arrangements were developed on the basis of the characteristics of the DNO's own end-customers. IDNOs typically connect to the DNO network at HV, but their demand characteristics do not generally match those of an HV end-customer. Rather the characteristics of IDNO networks reflect those of their own typically LV end-customers. It is appropriate to develop additional yardsticks for IDNOs, as in general these will be different from directly connected business customers of a similar size. In particular, the load shapes of IDNO sites will be different. Also, the costs incurred in distributing units to the IDNO boundary may be different from those to a similar single DNO end-customer. Furthermore, the IDNO's own charges to its LV customers, particularly domestic, are unlikely to include a capacity charge component, which leads to a potential mis-match in the structure of the host DNO's and the IDNO's charges.

We have sought to address these concerns through our interim proposals, with a view to implementation from 1 October 2008, subject to a non-veto decision by the Authority, following the consultation by Ofgem, which is in progress.

However the structure of charging arrangements for IDNOs is only one aspect of a bigger question in relation to charging. The existing regulatory framework for DNOs seems to be directly in conflict with the principles of competition where IDNOs operate out-with the price control and incentive framework applied to DNOs and are able to offer asset values while DNOs are prevented from offering tariff support.

In recent dealings with a number of Development Agencies in our franchise areas, we have been told that the removal of tariff support has been at the expense of stimulating the economy of the areas in question. The Agencies have also highlighted that there is a desire for DNOs and the Regulator to look more "strategically" at reinforcing the network to accommodate key economic developments and that this may raise questions over connection charging policies. These policies may also be relevant in the context of renewable Developers.

### **2.6.3 Reporting**

Currently we believe the annual Competition in Connections report produced by Ofgem significantly understates the actual level of competition across each franchise area. Ofgem could more accurately reflect the level of competition by reporting connections contracts won (including volumes and types of end customers) as well as connections physically delivered. This would overcome the inherent lag (typically 6-24 months) between contracts won, which are the real measure of competition, and delivered physical connections on the ground. The annual report has in our view significantly understated the level of competition experienced in our two networks areas.

### **3 Networks - investing to preserve the safety and continuity of energy supplies and ensure that networks are sufficiently resilient to severe weather events**

#### **3.1 Building block approach**

*The building block approach proposed is a generally positive development from DPCR4 and we hope will allow a more coherent settlement across capex and opex allowances.*

We have some specific concerns, regarding comparability between companies in-sourcing and outsourcing the same activities, that will need to be dealt with in this work, but we believe what is proposed is a pragmatic step forward.

Specifically, we welcome Ofgem's recognition of the consequences of significant input cost pressures through the creation of a building block designed to address this concern. We believe this is an increasingly significant factor affecting the whole of our industry, and because of global market conditions, leaves DNOs significantly exposed in terms of cost and asset risk.

#### **3.2 Information Quality Incentive**

*We will work constructively with Ofgem to develop the IQI mechanism.*

At least two DNO groups, whose FB PQ submissions were assessed as being most robust, as measured by the ratio of their DNO forecast to FB PQ at DPCR4, are among those companies who are significantly under spent to-date. These companies are currently earning a high additional return for the quality of their forecasting and, in addition, reaping a higher incentive rate for the significant and unanticipated out-performance of their capex.

It is therefore critical that the objective assessment of companies forecasts is made more robust going forward and that there is sufficient time allowed within the process to adequately review investment plans. If the IQI/menu based incentive mechanism is not sufficiently specified and communicated in advance of DNO FB PQ submissions then DNOs will require the opportunity to resubmit plans.

We are also concerned that in the form of the sliding scale, the IQI does not allow companies to invest beyond the allowances. It has been argued by Ofgem in the past, that the sliding scale allowance does provide companies with the incentive to spend more than the allowance. However, consider an asset replacement which is a straight forward cash cost required entirely to maintain or renew an existing asset with no additional financial benefit. Under the current scheme if that investment takes the DNO above its allowance for capex then it could only recover 69% of the investment, under the sliding scale mechanism. It is difficult to persuade investors or financial analysts of the merits of such an investment.

It is important that each DNO is adequately funded to deliver a safe, secure and sustainable network and that the cost drivers facing DNOs are recognised by the cost

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analysis. For example, cost drivers overlooked at DPCR4 included tree density around DNOs overhead line networks and fault rates.

Going forward we propose to work constructively with Ofgem to find an efficient means of allowing companies the opportunity to invest more flexibly while also providing adequate assurance to customers that investment is both merited and cost-effective.

### **3.3 DPCR4 and DPCR5 capital allowances:**

*We welcome the fact that Ofgem expect the step change in capital allowances required by industry in DPCR4 to continue into DPCR5 as a consequence of the age and condition of the networks and as a consequence of rises in input costs.*

We note Ofgem's concerns regarding DNOs delivery against DPCR4 capital allowances. This underspend has occurred despite the introduction of Ofgem's IQI mechanism, which was designed to address the threat of companies overbidding capital allowances.

SP Distribution and SP Manweb are spending in line with DPCR4 capital allowances.

At DPCR4 the issues around capacity to deliver were considered thoroughly by our company and reflected into our profiles for investment plus our recruitment and resource planning. SP Energy Networks has been amongst the most active in our industry in the recruitment of graduate electrical engineers and craft apprentices<sup>4</sup>.

Nonetheless the market factors we mentioned above have affected the programmed volumes of activity that we have been able to undertake, in particular increases in raw material prices, for example the cost of a 33 kV transformer has increased by c. 80% in the last 3 years. As a result of this global market phenomenon our asset risk indices have increased and due to the financial constraints imposed by the current structure of the sliding scale mechanism, now referred to as IQI, this is an issue that will need to be dealt with at this price control review.

### **3.4 Operating cost allowances:**

*We believe that all DNOs are struggling to achieve operating costs in line with allowances, as a result of the DPCR4 cost analysis failing to capture all of the relevant cost drivers faced by DNOs.*

The RRP reporting for 06/07 demonstrated that all DNOs are struggling to achieve operating costs in line with opex allowances, we believe as a result of the DPCR4 cost analysis failing to capture all of the relevant cost drivers faced by DNOs, and of the imposition by the Regulator of an efficiency stretch which is unsustainable.

Going forward we expect that through careful consideration of the "building blocks" approach proposed by Ofgem, this can be addressed.

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<sup>4</sup> In the last 3 years ScottishPower Energy Networks have recruited 35 trainee engineers, 125 craft apprentices, and c. 45 adult craft trainees.

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### 3.5 Recruitment and Resource Planning:

*DNOs are currently facing a number of important long-term challenges including delivery of significant investment programmes, the need to fund R&D, skills development and recruitment of new resources into the industry.*

These challenges are growing in significance given the requirements for increased capital programmes and the potential for significant changes to DNO's role in relation to delivering Energy Policy.

We have been working with the Power Sector Skills Strategy Group that was established in July 2007, to capture both the challenges and range of solutions that the Industry shall need to implement, and will continue to work in this forum, and proactively with Ofgem, to ensure that the challenges presented are considered through the DPCR5 process.

### 3.6 Stakeholder engagement:

*We believe that the DPCR5 process will benefit from the explicit emphasis upon greater stakeholder engagement to inform stakeholder plans.*

We believe that DNOs should engage with key stakeholders through formal stakeholder events, and with a broader sphere of stakeholders through an internet based consultation. This approach should enable DNOs to present plans that are locally supported and informed where appropriate.

SP Energy Networks first phase of stakeholder events are planned for 31<sup>st</sup> July in Glasgow and 6<sup>th</sup> August near Liverpool. The details of the events and how stakeholders can register to attend will be published shortly on the SP Energy Networks website.

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**4 Financial Issues - ensuring that electricity network companies are able to continue to attract investment against a background where successive price reviews have significantly increased the risk borne by DNO**

**4.1 Cost of Capital**

*At a time when a significant proportion of the UK asset base is reaching the end of its operational life it is crucial now, more than ever, to set a cost of capital that enables DNOs to attract and retain the funding required to meet a step change in capital expenditure levels.*

Attracting the appropriate level of funding whilst maintaining the financeability of the companies is key to delivering Ofgem's key priorities of tackling climate change and providing secure and more sustainable networks for customers.

We agree that an appropriate cost of capital depends on the overall balance of risks and rewards contained within the overall price control settlement. For SP in particular, the impacts of various incentive mechanisms and revenue drivers have combined to ensure that any perceived headroom within the DPCR4 allowed cost of capital has been materially eroded. It is vital that Ofgem fully recognise these and other non-systematic risks faced by SP and other DNOs when formulating the allowed cost of capital.

Ofgem have highlighted that there have been several sales of regulated utilities at significant premia to RAV. We would urge caution over making any inference that this arises from an overly generous allowed cost of capital. Recent acquisitions and premiums reflect only a snap-shot of recent market conditions characterised currently by high demand for index-linked income streams and are the result of a wide range of other factors. In particular we believe that high MARs can result from potential unrealistic assumptions around RAV growth, outperformance of regulatory allowances and incentive revenues. In some cases there is also an element of assumed synergy and efficiency achievable from larger Groups and their non-regulated businesses.

We would also point to the lessons learnt by OFWAT following the 1999 Price Review in water, where a combination of factors including high premiums on regulated assets, perceived out-performance of returns, political pressure on prices, all of which took place during a time of significant policy debate led to a sharp reduction in allowed rate of return. As a result share prices fell very sharply, and for the rest of the period going forward over a period of 5-years, the market value of the companies lay below the regulatory asset values. This significantly undermined company and investor confidence and as result companies turned to more highly geared structures and simultaneously their appetite to undertake large CAPEX programmes significantly diminished.

Additionally, current problems being experienced in financial markets should serve as a reminder that over a five-year period DNOs can be faced by challenging conditions,

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particularly in this instance, surrounding the terms upon which companies are able to raise new debt.

We strongly believe that the trend in the allowed cost of capital observed in the decisions affecting the electricity and gas sectors must now reverse and that for DPCR5 an allowed cost of capital around the level seen at DPCR4 should be seriously considered.

### **4.2 Financeability**

***Consistent with previous price control reviews, Ofgem should continue to test proposals for consistency with credit ratings comfortably within investment grade.***

The current licence obliges companies to take all appropriate steps to ensure that they maintain an investment grade issuer credit rating at all times.

With companies being faced with raising new debt to fund higher capex programmes it is important that Ofgem reassess its view of 'comfortably within investment grade'. We believe that companies need to be within the 'A' range of credit ratings and that the floor should therefore be 'A-'. We believe that the current ratios themselves are fit for purpose as metrics, although we are of the view that consideration of equity-based ratios such as dividend cover may also be appropriate.

We believe strongly that these should also be tested for the duration of the price control period to ensure that they do not exhibit a deteriorating trend since such a pattern could in itself trigger a credit rating downgrade and thus make raising finance more costly. In addition we believe that these should be stress-tested for adverse shocks and that appropriate headroom should be maintained.

### **4.3 Accelerated depreciation:**

***We believe that accelerated depreciation remains an essential means of applying a financeability adjustment in electricity distribution where it is well understood, is predictable and transparent, and is NPV neutral thus ensuring companies have adequate cash-flows for investment and customers are protected financially.***

SP Distribution and Scottish Hydro Electric Power Distribution are the last remaining DNOs to face the post vesting "cliff face". It is crucial that the resultant, very material, shortfalls in revenues are mitigated using the same approach and specific treatment as was previously applied to all other DNOs; i.e. the accelerated depreciation of post vesting assets using an assumed 20-year life with a 15-year catch up and that financeability tests are carried out from this baseline.

We understand Ofgem's concerns regarding depreciation rates and their long-term impacts. We believe however that in the interests of regulatory consistency the current precedent applied at DPCR4 and more recently for the Scottish companies at the TPCR should be extended for the duration of DPCR5.

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We recommend that a number of possible solutions are fully considered as part of Ofgem's RPI at 20 project when each DNOs RAVs and capex profiles can be modelled in detail in order to find an optimal strategy going forward. We believe that any attempt to reset depreciation rates as part of DPCR5 would introduce unnecessary complexity and uncertainty, at a time when the priority is to fund the increased investment programmes of the DNOs.

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**5.0 Process and timetable**

*We are broadly supportive of the wide-ranging consultation approaches intended to be utilised throughout DPCR5 and welcome the introduction of more formal DNO stakeholder engagement and development of business plans based on individual DNO need.*

We recognise the value of impact assessments in appropriate circumstances. For example, we would highlight the large financial impact of any proposal by Ofgem to alter assumed asset lives for the purposes of determining depreciation allowances.

Recent experience during the last Distribution review and more recently in Transmission has shown that too little time has been allowed for the process of licence drafting and amendment, leading to last minute debate on the implementation of key policy issues and mechanisms. We urge Ofgem therefore to attach sufficient importance to, and carefully plan, the process of licence drafting.

Overall it will be vital that Ofgem ensure that key economic mechanisms designed to deliver policy objectives, for example the IQI process and parameters, are provided to DNOs sufficiently in advance of the detailed business plan submissions in January to enable DNOs to properly react to the incentive. As a result this will involve early drafting and completion of 3 key components: IQI parameters, DPCR4 legacy or roll over issues, and provision of the financial model.