Regulation & Commercial

Hannah Nixon
Partner, Transmission
OFGEM
9 Millbank
London
SW1P 3GE

Your ref

Our Ref

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Contact / Extension
Scott Mathieson
01698 413475

Dear Hannah

Open Letter Consultation on Transmission Price Control Review 5 (TPCR5) – the Way Forward

This response is submitted on behalf of SP Transmission Limited, which as the regulated transmission owner, owns and maintains the electricity transmission network in central and south Scotland. SP Transmission Limited is part of Iberdrola Group which is one of the largest energy utilities in the world operating across four continents.

Overall; we cautiously welcome the introduction of the RIIO regulatory framework.

Our main points are:

- Iberdrola has become acutely concerned by the diminishing returns available to UK regulated businesses in recent years, which when combined with higher regulatory complexity and risk create clear differentials with other international investment propositions.

- We are concerned that recent regulatory pronouncements within RPI-X@20 suggest that revenue shortfalls should be addressed by equity injections without the apparent acceptance or recognition that this pushes up the cost of equity at a time of very significant demand for funds

- We support the development of primary outputs and believe that it is important that outputs are complementary, measurable and within the control of the transmission licensee.

- We have reservations that the speed of introduction of the RIIO process for TPCR5, running in parallel with other regulatory initiatives (e.g. TPCR4 roll forward, ENSG funding & DPCR5 RRP), will mean that there is limited time within the TPCR5 timetable to properly develop primary outputs and prepare a detailed business plan, and

- We welcome the introduction of a Price Control Review Forum (PCRF). It is important that the Scottish transmission licensees are directly represented at this Forum.

Regarding our plans for TPCR5 I would also advise you that we intend to initiate our own stakeholder engagement process in October to include both pre-consultation and full consultation processes.

Financial

Iberdrola have become acutely aware of the diminishing returns available to UK regulated businesses in recent years and the differential with other international investment propositions. For instance, Iberdrola USA have recently seen the conclusion of the New York Rate Case where its regulated businesses have been allowed a baseline return on equity of 10% nominal, before potential outperformance. Higher returns are also available for specific expenditure in other States where Iberdrola have an interest e.g. the Maine Power Reliability (Transmission) Programme where returns of 11.64% are available again before further outperformance opportunity of 125 basis points. Set against this background, returns on equity of under 9% (using 6.7% allowed at DPCR5 and 2.0% for CPI US equivalency) are clearly becoming unattractive without very significant outperformance.

It is a matter of some concern too, that recent regulatory pronouncements suggest that modelled short term revenue shortfalls should be addressed by equity injections and yet there does not seem to be any acceptance that the corollary of this is that the baseline rate of return must increase commensurately.

We trust that this will be carefully considered as part of TPCR5 in conjunction with upward pressure on the cost of equity. Finally, and in general, given the unprecedented scale of required infrastructure investment required globally and the resultant heightened competition for funding we believe that regulators must seriously question whether their previously predominantly backward looking basis for setting allowed returns remains appropriate if delivery of low carbon targets are to be achieved.

RIIO

We welcome the recognition of the need for energy networks to play a full role in the delivery of a sustainable energy sector to facilitate the transition to a low a carbon economy. In particular, a significant increase in investment will be required, which will have to be adequately funded.

TPCR5 is the first price control review to be developed under RIIO and it should be recognized that this represents a major change from the existing arrangements. It creates considerable uncertainty and risk for network companies such as, for example, the proposed changes to financeability criteria discussed above.

The introduction of the RIIO regulatory framework therefore comes at a time of unprecedented challenges and opportunities for the energy sector and must not put at risk delivery of any of the United Kingdom’s wider targets regarding global climate change. We have recently seen examples of other developments, for example on provision of Offshore connections, where it would appear that Regulatory innovation has led to extended lead times for offshore connections, uncertainty and frustration among the customer base that we serve.

Process and Timescales

We would highlight the significant workload that TPCR5 represents given that we are also working with Ofgem on the TPCR4 Roll-Over and on ENSG reinforcements.

In terms of the TPCR5 timetable, we are concerned that there will be insufficient time to develop workable primary outputs to include in the December TPCR5 Strategy Initial Proposals, and also to complete a business plan by July 2011 which takes into account outputs from our stakeholder engagement process, and Ofgem’s March 2011 TPCR5 Strategy Final Proposals.

We welcome the introduction of a Price Control Review Forum (PCRF) and agree that there is merit in the group meeting on a regular basis to inform on various aspects of the Review. We believe that it is important for the Scottish transmission companies to be represented on this Forum and therefore do not agree with the proposal to limit the representation on the group to one from the transmission companies. Given the scale of investment to be undertaken by the Scottish transmission companies through to 2020/21, and the significant role they have in supporting UK energy policy, it is very important that these companies are fully represented.

SPT's Stakeholder Engagement Plans
In October we will initiate a four-week stakeholder pre-consultation process seeking stakeholder feedback on the challenges and the high level priorities for SP Transmission. We will use the outputs from this pre-consultation to inform a full stakeholder consultation which will run through to February next year. In undertaking these consultations, we will make use of extranet, stakeholder workshops, and meetings with key stakeholders as appropriate. We would prefer more time to undertake this consultation process and prepare our detailed business plan.

Business Plan Development
Ofgem requires the network companies to submit well-justified business plans under Sustainable Network Regulation and we note the detailed business plan guidance set out in Annex C. We agree that the business plan should be proportionate in assessing the price control package.

Development of Primary Outputs
Although we support the overall development of primary outputs across the six areas identified, we are concerned at the short period of time to develop primary outputs sufficient to inform the December strategy consultation. In particular, given the scale of investment it is very important that the development of outputs associated with major network investment should not be rushed.

Care must be taken in the design and calibration of primary outputs to ensure that they are measurable and within the control of the licensee. Outputs should be complementary to ensure that the objective of one output does not conflict with another; for example, there would be potential conflict if there is 'reliability' output to encourage the right level of network investment, maintenance and refurbishment and a 'planned unavailability' output to encourage the transmission company to minimize the period of an essential network outage.

In addition, it is also important that they do not distort decision-making and the allocation of resources such that customers' preferences are not properly reflected. Inappropriate incentives can unduly focus attention on less valuable activities to the detriment of other activities which customers may value more highly.

Finally, the development of secondary outputs / deliverables needs to be considered carefully to ensure that inappropriate "inputs" based mechanisms are not developed, which could result in Ofgem appearing to micro-manage the licensees' decision making.

Funding Arrangements
In developing outputs for TPCR5 it will be important to continue to ensure that essential load and non-load investment is adequately funded.

We agree that there are challenges in facilitating the growth and integration of renewable energy sources however the funding arrangements set by Ofgem for the Scottish companies at TPCR4 have proven to be a good framework for funding local infrastructure. It is notable that at TPCR4 Ofgem set a revenue driver to fund local infrastructure for 1734MW of transmission connected generation from April 2007 through to March 2012, and that we currently expect to connect 1756MW over this period, which is a very close outcome. We see no reason why a similar arrangement for local infrastructure could not be provided for TPCR5.

Ofgem has already designed and implemented an incentive framework to apply until the start of TPCR5 to fund essential ENSG deeper system reinforcement projects. We suggest that Ofgem considers extending this framework to apply from the start of TPCR5. Although it requires an annual review of progress against outputs, this pragmatic approach will incentivize delivery and costs.

In terms of asset replacement, we agree that there is a requirement for significant replacement investment in the electricity transmission networks. Working with Ofgem we hope that we can define asset risk output/s which help highlight if our annual asset replacement, refurbishment and maintenance work provides an overall network which meets stakeholder expectations.

Finally; we also recognize that much of the change affecting us comes at a time of great political uncertainty about the future role of Ofgem themselves. We recognize that it is undesirable and unproductive to have any regulatory body operating under significant levels of uncertainty. SPT would remark that generally Ofgem have been ultimately supportive of the necessary investments that need to take place in the UK and have put in place effective mechanisms to deliver that investment. Perhaps the only criticisms we would levy of the existing model are with respect to the speed of decision making, an over fixation with competition in relatively marginal areas in electricity and recent decisions on return that make investment in the UK less attractive. None the less; Ofgem compare favourably with other European and Global Regulators in our view and we think it is vital that their future shape is determined as quickly as possible in order to provide a stable base from which all parties can negotiate a price control that delivers value for those using our networks and that delivers against the United Kingdom's environmental targets.

Should you have any queries please do not hesitate to give me a call on 01698 413475 or
Alan Michie on 01698 413466.

Yours sincerely

Scott Mathieson
Regulation & Commercial Director