



SP ENERGY NETWORKS

Mr Dermot Nolan
Chief Executive Officer
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3 November 2014

Dear Dermot

Thank you for your letter dated 19 September 2014. I welcome your assurance that you want to ensure an outcome for RIIO-ED1 which is fair, non-discriminatory and delivers value for money for consumers. This letter sets out a number of issues that I would like to discuss in person with you. Assuming that you are in agreement, my personal assistant will contact your office to arrange a meeting between us. Given where we are in the RIIO ED1 process, I would urge that we meet as soon as possible.

Assessment of SPEN's investment programme

I note your explanation that the nature of Ofgem's price control benchmarking is to consider the efficiency of business plans "in the round". As I explained in my letter, Ofgem must make its decisions on a sound factual basis. Accordingly, I welcome David Gray's confirmation at the GEMA Committee meeting on 4th September that Ofgem must satisfy itself that any apparent differences in efficiency between DNOs disclosed by the benchmarking are real and are not due to justifiable differences.

We have two key concerns in this respect, firstly the operation of the top down totex models has a uniquely negative impact on our SP Manweb (SPM) business (with the exception of the WPD companies who are excluded from this process) of about £115m (£115m after 50% weighting, of an underlying gap of approximately £230m from the model). To put this in proportion, this accounts for nearly 64% of the total net £180m gap from the draft determination. The second key concern, which is directly related to the above, for SPEN remains Ofgem's assessment of SPM's 132kV programme within the disaggregated model which has a net £65m impact (50% of an underlying £130m gap from the model). Without closing the net funding gap that arises from the draft determination, through the qualitative adjustments we believe are necessary, asset risk will increase to unacceptable levels for SPM customers, whether measured globally or at an individual asset level.

At the GEMA Committee meeting on 4th September David Gray referred to companies only focusing on "downs" and not the "ups" within the cost assessment model. To make our position clear, with SP Distribution (SPD) we can see that the ups and downs in the cost modelling do net out to a package that we could deliver (setting aside our concerns with respect to the Smart Grid and RPE adjustments which are dealt with separately). However, SPM is in a fundamentally different position, there is no balancing upside and SPM faces a big deficit in funding as a result of how the modelling works. This has a direct implication for our ability to manage risk at acceptable levels in the SPM business and in our view increases asset risk to an unacceptable level in SPM if this is not addressed in the Final Determination.

Let me explain why in our view this problem is created through Ofgem's modelling. The disaggregated model that the Ofgem team uses reduces all company plans by £1.3bn, which is a consequence of a bias towards "cherry picking" that the model performs. However, this does provide the clearest view of where variances lie across all companies at a detailed level. In this model, SPM's gap is c£130m. The top down model in contrast removes £500m from the industry plans but nearly £240m of that is from SPM. Bringing these models together creates a £180m gap for SPM, but the top down model is the fundamental problem with the ED1 cost assessment for SP Manweb, compounded by the disaggregated model.

At previous price controls, top down modelling has only been applied to areas that are homogenous and not affected by investment cycle, such as Network Operating Costs. We have made representations on this being a key issue throughout the process and that there is too much reliance on

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totex modelling and insufficient weight is being given to our evidence, for example CBAs or investment cycle information, that needs to be taken into account and applied as qualitative adjustments to the totex model outputs.

The Ofgem "working level" team has explained that qualitative adjustments will be made to the outputs of their models in order to recognise such differences. In this regard, we have provided a range of relevant information to Ofgem during the RIIO-ED1 process, in particular about our investment programme. However, my team are concerned about the lack of information we have been provided as to how Ofgem has progressed on key areas of totex modelling, in particular elements of SPM's 132kV programme since the draft determination. Without thorough engagement or confirmation of the details of the investment plans which Ofgem is taking into account, we are not in a position to determine whether the programmes are being assessed on a factual basis.

SP Manweb (SPM) Special Case

We are aware that another DNO has challenged the SPM special case in its Draft Determination consultation response. We question the basis for such comments, particularly as they suggest for example that SPM should consider accepting more challenging customer interruption targets in exchange for a special case adjustment. We have provided substantial information to Ofgem that clearly explains how the SPM network design is fundamentally different to any other DNO network. However, we have subsequently had to explain to your team that Ofgem has in fact already embedded SPM's frontier urban network performance within the targets Ofgem has set for ED1. Only LPN with its 100% underground network has tighter Criticality Index (CI) targets.

Our concern has increased by the Ofgem team suggesting that any adjustment to cost allowances should be matched with adjustments to MEAV used in cost modeling. We have submitted a report from NERA that states that to make such an adjustment would be arbitrary and discriminatory, and if any adjustment was made to SPM then similar adjustments must be made to all other DNOs.

For example LPN has much higher MEAV arising from its 100% underground cable network, it will perform better in the totex models as a result, but also has Regional Wage adjustments and a regional special case.

This has raised concerns within my team that Ofgem do not fully appreciate the full extent of how different the SPM network is and that this could lead to arbitrary adjustments that could discriminate against SPM. Naturally, we would expect Ofgem in its assessment to objectively consider all the facts and seek assurance that it has taken into account the detailed submissions made by SPEN when making the adjustments in its Final Determination.

Ofgem's Proposals for Establishing Secondary Deliverables

The determination of appropriate secondary deliverables is a key element of RIIO-ED1. If SPEN does not meet the deliverables it will face penalties. We have both procedural and substantive concerns in connection with Ofgem's proposals to establish secondary deliverables. Again I would underline at the outset, this is specifically an SP Manweb issue and arises as a consequence of the detrimental impact that financial modelling has on SPM. In simple terms we are not currently in a position to say that the overall funding is adequate to address the asset risks we face, whether at a global or disaggregated level.

As regards procedure, we received first sight of Ofgem's proposals after close of business on 16 October. These proposals did not form part of the Draft Determination consultation or any other formal or informal consultation by Ofgem. These proposals and supporting information require careful analysis, yet we are expected to respond in ten working days. This is unreasonable. It is essential that we are fully and fairly consulted about this material aspect of RIIO-ED1 and sufficient time is allowed to enable us to provide an informed response to Ofgem.

On substance and as a consequence of where we find SP Manweb uniquely positioned, we are deeply concerned by the implications of Ofgem's approach to mechanistically translate the outputs of Ofgem's cost models into secondary deliverables on a line by line basis. This is made worse by the approach not reflecting the full scale of the reductions identified by Ofgem's models. Whilst your team often refers to a global measure of asset risk, and an envelope that we can work within to manage that risk, ultimately that measure is created from a detailed assessment of our proposed Health / Criticality Index work programmes.

Although we welcomed the opportunity to discuss Ofgem's proposed secondary deliverables at the 28 October 2014 bilateral and recognise that a number of concerns have been taken away for further consideration, we fundamentally believe that DNOs must be allowed to restate their secondary deliverables based upon customer and network risk. Although Ofgem propose to set an overall "risk points" target for ED1, the fact that any divergence from that target will be reconciled to line by line asset volumes and unit costs effectively means that to all intents and purposes Ofgem are setting the ED1 "contract" at that level of detail.

If the Final Determination presents a material reduction in totex then it is essential that SPEN is provided the opportunity to restate its secondary deliverables to reflect the reduction in totex imposed by Ofgem. These reductions cannot be applied mechanistically.

Please note that such a restatement would not represent SPEN's acceptance that the levels of totex or the revised outputs resulting directly from that totex are acceptable. This is a judgement that my Board will make once they are in receipt of all relevant information including the proposed secondary deliverables package. Any decision taken by my Board must be made further to full consideration of the overall totex award as weighed against the secondary deliverables commitments.

Further areas of continued disagreement

There are a number of key points that I have raised in my previous letters to you. We continue to disagree with Ofgem's change of approach in relation to RPEs and 'smart stretch'. We also continue to disagree with the overall position in relation to WPD and will carefully assess SPEN's position relative to WPD when Ofgem publishes its final determination. I would emphasise again that any assessment of SPEN's plan must include in its aims the achievement of an objective and fair determination.

We have also consistently stated our disagreement with Ofgem's assessment of the appropriate cost of equity and the "translation" of the NIE cost of equity. You mention that Ofgem has discussed the translation of the CC's assessment with the CMA. It would be helpful if a detailed note of the entire discussion could be passed to us so that we have a full understanding of the position.

Assistance

We are committed to working with Ofgem to secure an outcome for RIIO-ED1 which is fair, non-discriminatory and delivers value for money for consumers. I appreciate that Ofgem is completing its analysis in order to inform GEMA's final determination. Please be assured that you are welcome to get in touch with me at any time to discuss RIIO-ED1, and that I (and my team) appreciate the need to respond quickly to any requests from Ofgem or the members of GEMA for assistance or information in the period up to the publication of the final determination.

I would ask that this letter be circulated to the other members of the Committee.

Yours sincerely



Frank Mitchell
CEO, SP Energy Networks

CC Mr David Gray

