



SP ENERGY NETWORKS

Mr Dermot Nolan
Chief Executive Officer
Gas and Electricity
Markets Authority
9 Millbank
London
SW19 3GE

Your ref.

Our Ref

Date

11 September 2014

Dear Dermot,

Presentation to the Committee of the Authority

I would like to thank you and your fellow members of the GEMA Committee for meeting us on 4th September 2014 to discuss SPEN's key issues in relation to the RIIO-ED1 draft determination.

It is critical at this stage that our respective teams continue their ongoing engagement and discussions about the draft determination and our business plan. We want to work with Ofgem to ensure that outstanding issues in RIIO-ED1 are resolved to ensure high quality outcomes for consumers. We also appreciate that Ofgem must meet its own legal obligations and treat DNOs in a fair and non-discriminatory way. It is in this spirit that I write to emphasise a number of points arising in the context of our meeting.

Proper assessment of SPEN's investment programmes


At the meeting we discussed the appropriate assessment of SPEN's investment programmes and set out a summary of errors and issues (which we have logged with Ofgem for resolution), with an aggregate impact of more than £325m.

One of our concerns, representing more than £100m of that £325m, is that Ofgem's modelling is not properly adjusted to take account of legitimate factual differences between DNOs. This issue has its most material effect in relation to the assessment of our 132kV investment programme, asset refurbishment unit costs and civils costs. SPEN has requested funding for a range of schemes and has committed to outputs dependant on the completion of these schemes. I know that you will agree that Ofgem's assessment of these schemes must be made on a sound factual basis.

Ofgem must consider all relevant information before determining any element of SPEN's investment programmes. As an example, SPEN must submit a well justified

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Cost Benefit Analysis (CBA) for major schemes and programmes, supported by robust asset health information. This is, as Ofgem has said, a critical input to SPEN's business plan and therefore Ofgem must consider this information. This is consistent with Ofgem's approach at RIIO-T1.

Our investment programmes are a central part of our plan to deliver high quality outcomes for present and future consumers and the general public, by maintaining security of supply and ensuring the continued safe operation of our network. Ofgem's final decision must give appropriate weight to these important factual considerations and be made following a careful review of all relevant information.

Fundamental Changes in Policy

SPEN thoroughly appreciates and supports the significant benefits of smart grids. SPEN will deliver significant efficiencies, (included in our business plan), as a result of smart grids. However, as we explained in our presentation to the Committee, we have material questions about the analysis underpinning Ofgem's conclusion that SPEN can commit to make further savings at this stage. We are also surprised that Ofgem is considering fundamental changes to its approach to RPEs and smart grids at this stage of RIIO-ED1. As explained in my letter to you of 20th June 2014, any deviation from previous RIIO policy and process would be a key concern for my Board. There have been no material factual developments in connection with RPEs and smart grids since the determination of the fast track that would justify a fundamental deviation. If SPEN's allowances for RPEs and efficiencies for smart grids are determined on a quite different basis to those of WPD this will lead to a significant difference in treatment between the two DNOs. We can identify no justification for this and it would give WPD a significant unfair advantage. Therefore, the proposed change in approach would, if implemented, be discriminatory and unfair and threaten to distort the RIIO regulatory regime.

Cost of equity

As I explained in my letter to you of 20th June 2014, our March business plan set out a clear justification for a cost of equity of at least 6.4%. At our meeting we explained how an appropriate "translation", on an empirical basis, of the Competition Commission's NIE price determination was consistent with a Cost of Equity of at least 6.4%. Ofgem continues to insist that a cost of equity of 6% is appropriate. We do not believe that there is any proper basis for a conclusion that SPEN should receive a cost of equity lower than WPD's. The different cost of equity is discriminatory and unfair.

Overall position relative to WPD

We discussed SPEN's treatment relative to WPD during the meeting. Ofgem's current approach leads to a reduction in SPEN outputs and TOTEX. The difference

in treatment between SPEN and WPD is extremely significant and cannot be explained as a proportionate reward for being fast tracked.

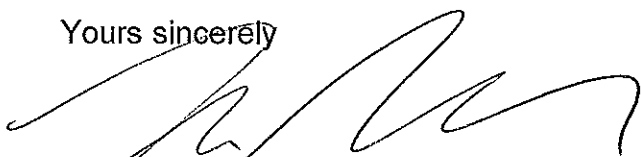
The differential severely undermines the reliability of the RIIO model and regulatory regime, to the detriment of present and future consumers and investor confidence. We would emphasise that RIIO-ED1 is a "framework contract" for outputs which SPEN commits to deliver over 8 years. We are therefore very concerned by comments made at the meeting that indicate that any disproportionality between the treatment of WPD and other DNOs could be addressed/ adjusted through the RIIO-ED2 fast track process to enable any DNO to be able to achieve fast tracking at RIIO-ED2. This would not address the discriminatory and unfair outcome which would, in fact, occur during RIIO-ED1.

All stakeholders expect the RIIO regime to be operated in a fair and even handed way. The differential points to a need to revisit a range of critical aspects of the draft determination at this stage. On the current assessment, SPEN will be underfunded and placed at a significant disadvantage in seeking to meet the proper requirements of its stakeholders and to discharge its legal obligations.

RIIO-ED1 is critical to SPEN's stakeholders and I am therefore fully engaged in RIIO-ED1 on a day-to-day basis. I am sure that you appreciate, as I do, the importance of achieving a fair and non-discriminatory outcome which delivers a high quality service to consumers. You and I both have significant responsibilities in this context and we both need to have a clear overview of the programme and the combined effect that each area of assessment has on SPEN and its stakeholders. Accordingly, I emphasise that you are welcome to get in touch with me at any time to discuss any aspect of RIIO-ED1 at this critical phase.

I look forward to hearing from you in relation to this letter and my letter of 20th June and I would ask for this letter to be circulated to the other members of the Committee.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Frank Mitchell', written over a horizontal line.

Frank Mitchell
CEO, SP Energy Networks

CC: Mr David Gray

