SP Transmission & Distribution

Response to Ofgem Consultation Paper:

Electricity Distribution Price Control Review
Update Paper
September 2004

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Members of the ScottishPower group

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EXECUTIVE SUMMARY

While we welcome some positive movement in terms of allowed revenue from the Initial Proposals, we are concerned that insufficient account has been taken of a number of significant issues that we have raised. Our major concerns are summarised as follows:

- The deferral of depreciation revenue for SP Distribution until 2010 would be discriminatory as it would be inconsistent with Ofgem's well established precedent of dealing with the pre-vesting depreciation 'cliff-edge' when it occurs.
- The cost of capital used in Ofgem's proposals, 4.6% fully-post tax, is not sufficient to allow companies to attract and retain equity funding and does not take adequate account of the increased uncertainty and risk to returns from exposure to incentive regimes.
- Our companies have been disadvantaged relative to the industry under the sliding scale mechanism because insufficient account has been taken of a number of fundamental, company specific, capital expenditure requirements.
- Ofgem's approach to the RAV roll-forward has resulted in excessive RAV deductions for our companies.
- We agree that SP Manweb's CI target should be based on the upper quartile however Ofgem's calculation of this target is not statistically robust and results in a more onerous target than the 'true' upper quartile.

The following actions are required to address these concerns.

DEPRECIATION IN SP DISTRIBUTION

The depreciation 'cliff-edge' should be dealt with in 2010, when it occurs, in-line with Ofgem's well established precedent.

- Ofgem has established a precedent for dealing with the 'cliff-edge' when it occurs.
- The suggestion to defer revenue to 2010 is discriminatory as it is inconsistent with this precedent.

COST OF CAPITAL

The allowed cost of capital should be at least 5% fully post-tax, consistent with the top-end of Ofgem's range, to enable companies to attract and retain equity funding.

- The industry has submitted empirical evidence that strongly supports a figure at the top-end of Ofgem's range.
- Historically, regulatory decisions on WACC have led to a flight from equity and we are very concerned that this will be the case if Ofgem's figure is perceived as being too low.
- Investors believe that the water sector is an appropriate benchmark and there is a clear expectation that the allowed figure will be consistent with that allowed in water.
- Ofgem's mid-range figure is some 0.5% less than the figure of 5.1% fully post-tax proposed for water. The full extent of this gap cannot be justified when electricity is seen as at least as risky as water.

NETWORK INVESTMENT REQUIREMENTS

Allowances for base case capital expenditure should be increased by £44m to secure the long-term safety, reliability and sustainability of our networks. In addition, our companies must be treated equitably under the sliding scale mechanism.

- The PB Power benchmark is not robust for our companies and does not take account of a number of company specific aspects of our requirements.
- The benchmark should be increased to include £24m of switchgear expenditure in SP Manweb and £40m of expenditure for load related reinforcement across both licensees.
- The benchmark should be increased to include £31m of HV cable replacement expenditure or, if Ofgem remains of the view that a 'fix on fail' approach is best, £31m should be removed from the company base forecast in the sliding scale mechanism.

QUALITY OF SUPPLY FOR 'WORST SERVED' CUSTOMERS

An additional £32m of capital expenditure is required to fund improvements in quality of supply for worst served customers and communities.

- We are very disappointed that Ofgem has taken the view that the costs do not justify the benefits and has not allowed any expenditure to improve service for worst served customers.
- Discussions with customers and their representatives indicate a clear requirement and willingness to pay for improvement initiatives.
- The cost of our programme equates to approximately £275 per targeted customer which is significantly less than the industry average of £1000 per customer quoted by Ofgem.

SP MANWEB CI TARGET

SP Manweb's CI target should be 50 CI rather than the 47 CI calculated by Ofgem.

- We agree with Ofgem that the target should be based on the upper quartile.
- The target of 47 CI proposed by Ofgem is not a statistically robust calculation of the upper quartile.

RAV ROLL-FORWARD

£33m of efficiently invested non-operational capital expenditure, in excess of the DPCR3 allowance, should be included in the RAV. In addition, the amount of indirect costs included in the RAV should be increased by £50m.

- The non-operational capex that we have incurred has either provided direct benefits to customers or was required to comply with regulatory requirements. The level of investment was significantly influenced by our relative position on the investment cycle.
- The decision to use 2000/01 data to determine the benchmark level of indirect costs to be included in the RAV is arbitrary and the data used is incomplete and inconsistent. Ofgem's use of a 5% bandwidth is insufficient to account for these problems.

Throughout this price review process we have emphasised our commitment to working constructively with Ofgem to deliver a successful price review outcome, balancing the interests of customers, shareholders and all other stakeholders. We believe the issues set out above need to be adequately addressed if this objective is to be met.

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SECTION 1: METERING

1.1 SUMMARY

Our position on the various issues associated with this area of work is summarised below:

- We are generally supportive of the proposals for Meter Asset Provision (MAP) but our position remains that termination charges should apply when suppliers choose to remove metering assets early.
- Our main concern in the area of Meter Operation (MOp) is the continued absence of detailed, clearly documented, proposals.
- We continue to support, in principle, the proposal for a revenue cap for MOp but would reiterate that the revenue driver should be based on the volume of visits.

1.2 METER ASSET PROVISION

1.2.1 We generally support Ofgem's proposals for MAP, in particular the setting of the four price caps and the use of non-discrimination provisions in setting charges for other meter types. Our major concern relates to Ofgem's opposition to termination charges where assets are unnecessarily removed early. Ofgem's approach goes against the principles of cost reflective pricing and reduces the economic signals to promote efficient investment. We urge Ofgem to again reconsider its approach.

1.2.2 Ofgem has accepted the risks that DNOs face in relation to the early removal of pre-payment metering by introducing proposals to allow pre-payment price caps to be increased by up to 30%. However, this is not a satisfactory solution, as the increased prices would be applied to those suppliers that had

not changed meters early, effectively cross-subsidising suppliers that had already changed.

1.2.3 It remains our view that termination charges are the most appropriate means of dealing with this issue. If Ofgem remains opposed in principle to termination charges then the asset lives for token meters should be reduced by 30% from day one with an appropriate increase in the price cap. Suppliers who have no intention of removing meters early could then agree termination charges with DNOs in return for lower charges based on the normal expected life.

1.3 METER OPERATION

1.3.1 Our main concern with meter operation is the continued absence of clear proposals from Ofgem despite extensive co-operation from all the DNOs. While we have had informal discussions with Ofgem that have provided a degree of reassurance, clearly documented, formal proposals are required as soon as possible.

1.3.2 We continue to support in principle the proposal for a revenue cap. However, we note that there is no discussion on how the inevitable under and over recoveries will be handled. Our understanding from further discussions is that Ofgem expects that prices will be adjusted frequently to minimise the problem. It has also been indicated by Ofgem that, as the amount of over/under recovery is unlikely to be material, then heavy policing of the cap would not be necessary, providing we had taken reasonable steps to ensure the cap was not breached.

1.3.3 It should be borne in mind that the current licence drafting for the meter operation price control caps revenue in a particular year depending on movements in activity carried out by third parties during that year. It may therefore be difficult to manage compliance with the revenue cap within the year concerned, particularly if there is a step change in third party activity

late in the year. We would expect this to be clarified in the Final Proposals paper.

1.3.4 We support Ofgem's proposals in paragraph 2.30 of the September document regarding the inclusions and exclusions to the price control. For clarification the list should also include urgent metering services.

1.3.5 A major concern is the proposal to remove time-banded appointments from the definition of basic services. We currently offer time banded appointment where these are available and we consider that the JPW (Joint PES Workstream) agreements offer sufficient protection to manage costs. We have always been able to charge extra for these appointments, in order to control demand, but this has not been necessary. Therefore, the definition of basic services should be consistent with the June 2003 definition. If some DNOs are concerned about the volume of time banded appointments, then they should introduce appropriate charges. These should be within the revenue cap and not an excluded service.

SECTION 2: QUALITY OF SERVICE AND OTHER OUTPUTS

2.1 SUMMARY

Our position on the various issues associated with this area of work is summarised below:

- We are very disappointed that Ofgem's proposals provide little or no hope of quality of supply improvements for worst served customers and communities. Our proposed £32m of targeted expenditure in this area, equating to £275 per targeted customer, is substantially less than Ofgem's quoted industry average of £1000 per customer and should be allowed.
- We agree that SP Manweb's CI target should be based on the upper quartile, however Ofgem's calculation of this target is not statistically robust and results in a more onerous target than the 'true' upper quartile. A target based on the 'true' upper quartile is 50 CI rather than the 47 CI currently proposed.
- The CML target for SP Distribution is too onerous. An additional £13m of capex should be allowed for remote control equipment in rural areas or the target should be relaxed to 53 CML.
- The proposed escalation mechanism for severe weather events does not appropriately account for the exponential impact of an increasing scale of event.
- The definition of applicable 'one-off' events requires clarification.
- We are concerned at the lack of supporting detail on the new losses incentive.

2.2 WORST SERVED CUSTOMERS AND COMMUNITIES

2.2.1 We are very disappointed that Ofgem's proposals provide little or no hope of quality of supply improvements for worst served customers and communities. Our proposed £32m of targeted expenditure in this area, equating to £275 per targeted customer, is substantially less than Ofgem's quoted industry average of £1000 per customer and should be allowed.

2.2.2 Our discussions with customers and their representatives indicate a clear requirement, and willingness to pay, for such improvements. We therefore urge Ofgem to reconsider its position and allow our proposed expenditure. If no allowance is forthcoming then we will need to work with Ofgem to manage the communication of this decision to customers and their representatives.

2.3 SP MANWEB CI TARGET

2.3.1 We are pleased that Ofgem has recognised SP Manweb's frontier CI performance by proposing a target reflecting upper quartile performance. We recognise that this approach gives SP Manweb an opportunity to out-perform the target and thus to participate in the reward part of the CI incentive mechanism in a manner not dissimilar to that available to the frontier performing DNO for the CML measure.

2.3.2 However, the approach taken by Ofgem to calculate an upper quartile target for SP Manweb results in a more onerous target than the 'true' upper quartile. A target based on the 'true' upper quartile for CI performance is 50 CI rather than the 47 CI currently proposed by Ofgem.

2.3.3 CI is proportional to the product of :

- network reliability (measured by the number of faults per km), and
- the impact of faults (measured by the number of customers per fault divided by the number of customers per circuit).

2.3.4 Ofgem's current approach assumes that upper quartile CI performance in each of the 22 disaggregated circuit categories is reflected by the achievement of upper quartile performance in each of the separate factors of network reliability and fault impact. This 'two quartile' approach taken by Ofgem is not statistically robust. A significantly more robust, 'single quartile' approach for arriving at an upper quartile CI target for each of the 22 disaggregated groups, would be to calculate the upper quartile of the combined impact of the two variables. This provides a target of 50 CI for SP Manweb.

2.4 SP DISTRIBUTION CML TARGET

2.4.1 The CML target for SP Distribution is too onerous. Indeed we believe that Ofgem's process, which sets all companies the challenge of reducing the average duration of customer interruptions to today's upper quartile performance within 5-years, is exceptionally onerous. This cannot be justified by the level of understanding provided by the current approach to performance disaggregation and analysis which, for example, takes no account of local geographic and environmental factors that have a significant impact upon the performance of a circuit.

2.4.2 We recognise that considerable improvements in customer restoration times can be achieved through improved operational response to faults. A number of revisions to working procedures and shift working patterns are being implemented with the aim of delivering significant improvements in supply restoration times. We believe that these changes, together with the revenue allowances proposed in Ofgem's September paper, will enable us to achieve

15 out of the 18.3 CML improvement required to achieve the proposed 2010 CML targets.

2.4.3 However in the large, sparsely populated areas that stretch from Stranraer in the west to Berwick-upon-Tweed in the east, a distance of some 150 miles, there are many areas where it will not be possible for our staff to travel long distances quickly, particularly in adverse weather conditions. In these areas our analysis shows that it will be far more efficient for us to install facilities which allow us to remotely operate pole top switchgear. We have estimated that £13m of capital expenditure will be required over the five-year period to achieve the remaining 3.3 CML improvement.

2.4.4 Is summary therefore, we require an additional £13m of capex for remote control equipment in rural areas. If this capital expenditure is not allowed then the target should be relaxed to 53 CML.

2.5 EXCEPTIONAL EVENTS

Very Large Events

2.5.1 We fully support the point made on this issue in the letter of 7th October from the Energy Networks Association to Martin Crouch. This is summarised below.

2.5.2 For Category 4 events Ofgem's approach assumes a linear relationship between the prescribed period before compensation is due and the scale of an event. As a result, an extremely large event is required to significantly increase the period before compensation is due. In reality, however, as events become significantly larger the relationship between size of event and duration to repair will become non-linear, even exponential. We therefore fully support the proposal for a 'square law' relationship between the size of the event and the period before compensation is due.

One-off Events

2.5.3 In its latest proposals, Ofgem has attempted to describe single incidents that would, or would not, be considered as applicable for exclusion as one-off exceptional events. The principle behind these definitions appears to be based upon describing excludable faults as those with a cause outside the control of the DNO.

2.5.4 However, with the network design and security standards applied in the UK (e.g. Engineering Recommendation P2/5), events that result in the loss of supply to at least 25,000 customers are usually the result of two (or more) overlapping incidents within a localised part of the network. In such cases the first and second incidents could have very different causes with one incident matching Ofgem's definition of an 'excludable event' and the other not.

2.5.5 We therefore propose that Ofgem adopt a more generic definition that considers the incident or incidents which lead to loss of supply and defines non 'excludable incidents' in terms of Nafirs type fault cause codes. We are currently working with the industry to develop a suitable definition that is consistent with the principles underlying the proposals in Ofgem's September update paper.

2.5.6 In addition, we are concerned that Ofgem's proposal only to exclude the impact of events in excess of 25,000 Customer Interruptions or 2,000,000 Customer Minutes Lost exposes smaller and better performing companies to greater risk under the IIP incentive scheme. For example, based on Ofgem's current proposals, a single one-off exceptional event in EDF-EPN will only 'consume' 0.83% of EPN's 2010 CI performance target. However, the same event in either EDF-LPN, SSE-Hydro or SP Manweb will consume between 3 and 4% of their respective 2010 CI targets. This very unsatisfactory situation can be overcome by removing the full impact of exceptional one-off events from the DNO's reported performance.

Recovery of Severe Weather Payments

2.5.7 The latest draft licence modifications introduce a two-year delay into the recovery of severe weather payments. These payments could amount to several millions of pounds, per event, resulting in serious cash flow implications given that two or more events could arise within the two-year period.

2.5.8 We see no reason to justify such a delay. The revised arrangements should be consistent with the current interim arrangements and adjust allowed revenue in the year in which the severe weather event occurs.

2.6 LOSSES

2.6.1 We are concerned at the lack of supporting detail on the new losses incentive, particularly in the light of previous statements in the June proposals and earlier papers. For example, the update paper and the latest draft licence modifications make no reference to the rolling losses mechanism that was described in some detail in the March policy paper. This is an important issue that could affect investment decisions relating to loss reduction, particularly in the latter part of the next price control period.

2.6.2 Similarly, decisions on loss reducing initiatives will be influenced by expectations regarding the resetting of the losses benchmark in 2010. This is because of the possible effects of loss reducing investment on allowed revenue from 2010 onwards, which will depend on the combined impact of any rolling mechanism and the resetting of the losses target. The June losses paper indicated that a number of options were being considered. We think that a company-specific 10-year average to 2007/08 is likely to involve the least distortion of the options mentioned in that paper.

2.6.3 Additionally, further clarification is required on the treatment of loss reducing capex at the next price review. It must be made clear whether any additional capex invested for loss reduction will be penalised as over-spend

under the sliding scale mechanism. In addition, clarity is required on whether the criteria for "efficient" investment will take into account the relationship between cost and loss performance.

2.6.4 The proposed value of losses is based on a number of assumptions. The figure should be revised at the next price review as these assumptions may not hold valid at that time.

2.6.5 Draft licence modifications (special Condition C1, paragraph 6) currently provides for the allowed loss percentage to be revised up or down, without the consent of the licensee. This would involve significant regulatory risk for companies and it is therefore important that changes can only be made following full consultation with DNOs.

SECTION 3: COST ASSESSMENT

3.1 SUMMARY

Our position on the various issues associated with this area of work is summarised below:

- An on-going efficiency target of 1.5% per annum from the upper quartile position overstates the potential for future efficiencies.
- There should be further consideration of regional factors. This should not be limited to the issue of EDF-SPN wage costs as suggested by Ofgem.
- Consistency of approach in the treatment of mergers will require that we be allowed to recover the amount that we have paid in excess of Ofgem's £32m merger adjustment tax in respect of the merger of ScottishPower and Manweb. This excess payment, approximately £12m, should be recovered during the next price control period.
- The PB Power benchmark is not robust for our companies and does not take account of a number of company specific aspects of our capex requirements. This results in our companies being disadvantaged relative to the industry under the sliding scale mechanism.
- There is some scope for the adjusted company base forecast used in the sliding scale mechanism to be reduced in the area of high voltage cable replacement.
- The rolling capex mechanism introduced at DPCR3 was intended only to apply to savings against the capex allowance and not, as Ofgem has applied it, to necessary expenditure in excess of allowance.

3.2 OPERATING COSTS

Assumptions on Future Efficiency Improvements

3.2.1 Despite the reduction in the frontier (upper quartile) shift from 2% to 1.5% per annum, an on-going efficiency target of 1.5% per annum from the upper quartile position still overstates the potential for future efficiencies. We believe that a figure of 1% per annum strikes an appropriate balance, setting challenging efficiency targets while recognising that the scope for future efficiencies is very limited.

3.2.2 Our previous consultation responses have pointed out the flaws in the derivation of Ofgem's assumptions on opex efficiency improvements. These related to the interpretation of the analysis carried out by Cambridge Economic Policy Associates (CEPA), the selective use of the DNOs' own forecasts and the effect of weakened opex incentives on the delivery of future savings.

3.2.3 The reduction in the assumption to 1.5% per annum in the September paper seems to have been only made in response to the selective use of company forecasts. The other valid points that we have raised, particularly the issues around the CEPA analysis, do not appear to have been addressed.

3.2.4 The CEPA analysis suggested a range for operating cost improvement of 0.7% to 3.7% per annum. This is based on a number of assumptions which are fundamentally flawed, including:

- the productivity assumptions used for the UK economy are inappropriate;
- the top-end of the range used by CEPA is a completely unrealistic assumption of the potential for future productivity improvement; and
- the failure to separate the catch-up and frontier shift components of productivity.

3.2.5 The use of historical data without any appropriate adjustment for the fact that such inefficiencies no longer exist is clearly flawed. Indeed the latest set of normalised cost data in 2003/04 demonstrates that costs, far from continuing to fall, are actually rising. This reinforces our view that the historical trend rate of cost reductions is not sustainable.

3.2.6 CEPA admitted in their report that operating efficiency is likely to be the result of a "combination of catch up and frontier shift". We have seen no evidence from Ofgem to date to suggest that this has been reflected in assumptions for ongoing efficiency.

Composite Scale Variable

3.2.7 We note Ofgem's retention of 50 per cent network length, 25 per cent customers and 25 per cent units in the composite scale variable. Although this is only a proxy for the actual cost drivers for our business we support Ofgem's use of these weightings as a pragmatic solution to a complex issue.

Regional Factors

3.2.8 Historically, many companies have put forward arguments for their own regional factors to be taken into account, such as customer density, adverse weather, etc. Over the years these have all been debated and disregarded with the exception of EDF – LPN and SSE – Hydro, which have been acknowledged to be outliers.

3.2.9 We believe that there should be further consideration of regional factors but that this should not be limited to the issue of EDF-SPN wage costs as suggested by Ofgem. In particular, further consideration should be given to the additional costs faced by companies with other significant regional and geographic factors such as customer sparsity, topology, higher than average proportion of overhead line network, severe weather exposure etc.

Mergers

3.2.10 At the last price review we strongly opposed the merger adjustments which led to a 2 per cent reduction in revenue for SP Distribution and SP Manweb. In paragraph 6.43 of the December 1999 Final Proposals, Ofgem agreed that, "in the light of the arguments made by ScottishPower and Manweb it will be appropriate to reconsider these matters at the time of the next price control review".

3.2.11 As pointed out in a number of our previous consultation responses, other companies have had a more lenient policy applied and, as a result, we will have paid more than any other merged entity by the end of this price control period. Consistency of approach will require that we be allowed to recover the excess payment, approximately £12m, during the next price control period.

3.3 ALLOWED CAPITAL EXPENDITURE

Base Case

3.3.1 Insufficient account has been taken of a number of fundamental, company specific capex requirements and our companies are being disadvantaged relative to others under the sliding scale mechanism. Ofgem's sliding scale allowance should be increased by £44m and the following narrative sets out the specific amendments to Ofgem's latest proposals that we believe are necessary to:

- provide an allowance sufficient to meet our legal and licence obligations and deliver the Base Case objectives set out by Ofgem; and
- ensure that our companies receive fair treatment under the sliding scale mechanism.

3.3.2 The sliding scale mechanism requires a robust benchmark. However, the PB Power benchmark for our companies is not robust and is £162m less than our base case requirement. PB Power have not taken sufficient account of a number of company specific aspects of our capex requirements such as the unique nature of switchgear in SP Manweb's interconnected network.

3.3.2 Our previous consultation responses have emphasised that spending in line with the PB Power benchmark would result in an unacceptable increase in the risk to network safety and security and an overall deterioration in network performance. PB Power's consultants formed their view following a superficial assessment of our asset base and its future investment requirements. In contrast, our forecasts were developed from a detailed understanding of the specific requirements of our asset base and the application of robust Asset Risk Management policies and practices.

3.3.3 Our forecast is therefore significantly more robust than the PB Power benchmark and, as stated in previous discussions, we believe that there is a strong case for the benchmark to be increased by £162m in line with our forecast. However, there are two critical areas of investment where it is absolutely essential that we complete our full programme of works and consequently, at the very least, should be included in the PB Power benchmark. These are:

- Load-related network reinforcement, where PB Power's assessment is some £40m less than our requirements and is insufficient to meet the needs of our customers and our legal and licence obligations. Our requirements are derived from a robust assessment of underlying reinforcement trends, which we expect to continue at current levels, together with consideration of specific projects such as the European Capital of Culture initiative in Liverpool. We firmly believe that we will incur the level of expenditure that we have forecast.

- Switchgear replacement in SP Manweb, where PB Power's estimate of this expenditure is some £24m less than our requirements. We note that PB Power have accepted the need to replace switchgear ahead of failure due to the unacceptable safety risk and have supported our proposed replacement programme. However PB Power have not taken sufficient account of the unique nature of SP Manweb's interconnected network and the substation unit costs that are higher than industry average

3.3.5 We remain convinced that our approach of utilising new technology to target replacement of high voltage cables in advance of failure is the most effective and efficient means of managing this critical asset. We therefore believe that the PB Power benchmark should be increased by £31m to include our proposed expenditure in this area.

3.3.6 However, we acknowledge that there are differing technical views on this issue. If Ofgem's technical opinion remains that this expenditure is unnecessary and the customer service benefit that this investment would

bring does not justify the cost, then we will abide by this decision. The current shortfall of £31m, between PB Power's assessment of the required expenditure and our forecast, should then be excluded from the adjusted company base forecast in the sliding scale mechanism.

3.3.7 If the above changes to the PB Power benchmark and company base forecast were implemented then the PB Power benchmark would still be considerably less than our Base Case requirements. However, the additional allowance provided under the sliding scale mechanism would enable us to deliver our proposed programme for modernisation of overhead lines. We believe that this programme is essential to avoid a deterioration in network performance, and to maintain storm resilience by constructing lines to a standard suitable for the environment in which they operate. A shortfall of some £12m would remain and we would endeavour to mitigate the impact of this through capital efficiency.

ESQCR

3.3.8 Ofgem's position on costs relating to compliance with the Electricity Safety, Quality and Continuity Regulations, Regulation 18, is that most costs will be incurred after all site surveys are concluded in 2008. On this basis, it has been proposed that no 'ex ante' allowance be provided and that the appropriate level of costs will be reconsidered in 2008.

3.3.9 It is not correct to state that most costs will be incurred after 2008. To date, we have surveyed approximately 15% of the relevant parts of our network for compliance with the '3m clearance rule' and have found around 5% of this sample to be non-compliant (it should be noted that very few hazards have been identified which represent immediate danger). Extrapolation of the results of these surveys indicates a substantial programme of work with an estimated cost of £40m.

3.3.10 The DTI have not been prepared to grant a derogation from Regulation 18 and have made it clear that companies will be held liable to prosecution in

the event of an incident even if a programme of work to ensure compliance with the 3m rule has been agreed. As a result of this risk, and given the extensive programme of work that is required to ensure compliance, we believe that the only prudent approach is to set a target of rectifying lines within a two year period following the date that they are found to be non-compliant. Spreading the work over a period of time in this manner, will enable the programme to be delivered efficiently, and should ensure that all lines will be compliant by 2010, two years after completion of the survey work.

3.3.11 It is therefore essential that Ofgem provide an ex ante allowance for this work. A prudent estimate of the costs that we will incur prior to 2008 is £10m and we would strongly urge Ofgem to reconsider its position on this issue and provide funding that is sufficient to enable us to meet our legal obligations.

3.4 INCENTIVES

3.4.1 At this late stage in the Price Review process there are still several unanswered questions regarding the operation and implementation of the sliding scale incentive and the general capex/opex incentive. It is essential that the operation of these mechanisms is fully explained and codified in the licence amendments prior to issue of Ofgem's Final Proposals in November.

Sliding Scale Mechanism

3.4.2 Our response to the Initial Proposals expressed our concern around the sliding scale mechanism and the fact that, as proposed in June, the mechanism was unduly biased against companies with higher capex requirements. The latest proposals appear to increase the bias against these companies. Ofgem has stated that the mechanism has been changed to preserve incentive compatibility. However, this could be achieved without the bias that is contained in the current proposals.

3.4.3 The current mechanism places far too much reliance on the PB Power benchmark and disproportionately penalises companies that may simply have a difference in engineering opinion. Ofgem has provided no justification for the parameters set out in the updated sliding scale matrix in Table 4.7 of the September document.

3.4.4 The spread of rewards and penalties is disproportionate to any possible benefit to customers resulting from the operation of the scheme. In effect, rewards and penalties have been announced, and subsequently modified, many months after business plan questionnaires were completed.

3.4.5 Our position remains that the marginal incentive rate and the additional income for companies with higher capex requirements should be increased to address the current bias and provide a more balanced incentive.

Capex/Opex Incentives

3.4.6 A move to equalise incentives, by reducing those for opex, is counter-productive. The scope for out-performance is very limited, and stronger incentives are required as a result. We are very concerned that little detail is available on the capex/opex incentive that will be applied. Detailed and clearly documented proposals must be produced prior to the publication of Final Proposals. Any uncertainty will significantly weaken the incentive.

3.4.7 We have provided Ofgem with a spreadsheet that sets out, in detail, how a generalised incentive mechanism could work through the establishment of a drawdown reserve. This combines Ofgem's proposed three alternatives into one mechanism, providing a flexible way of taking into account companies' differing circumstances. In addition, this could potentially enable companies that had under-spent their allowances to return value to customers sooner than might otherwise be the case.

DPCR3 Capex Incentive Mechanism

3.4.8 We firmly believe that the rolling capex mechanism introduced at DPCR3 was intended only to apply to savings against the capex allowance and not, as Ofgem has applied it, to necessary expenditure in excess of allowance. We continue to strongly dispute Ofgem's interpretation that it was intended to apply to such expenditure.

3.4.9 Ofgem's policy of applying the mechanism to such expenditure, which was only made clear to companies in June of this year, has resulted in a revenue penalty of £9.7m for our companies. If it had been Ofgem's intention to apply the mechanism in this manner then this should have been clearly communicated at the beginning of the current price control.

3.4.10 There are a number of Ofgem documents that clearly indicate that the incentive was not intended to apply to expenditure in excess of the allowance. These were included in detailed submissions to Ofgem in our response to the Initial Proposals and in a recent letter to David Gray. We believe that the submissions that we have made to Ofgem on this issue prove our case and that Ofgem's decision to apply the capex rolling mechanism in the manner proposed is retrospective regulation.

SECTION 4: FINANCIAL ISSUES

4.1 SUMMARY

Our position on the various issues associated with this area of work is summarised below:

- The cost of capital should be at least 5% fully post-tax, consistent with the top-end of Ofgem's range, to enable companies to attract and retain equity funding.
- We are pleased that Ofgem has recognised the costs of the pension deficit and, specifically, has now accepted our position on the treatment of Early Retirement deficiency Costs (ERDCs). However, we have some remaining concerns with the modelling of the proposed allowance.
- The new incentives and risk-sharing mechanism in the area of tax allowances is not sufficiently developed to be introduced at this very late stage in the process.
- Ofgem's approach to the RAV roll-forward has resulted in excessive RAV deductions for our companies. Our major concerns relate to the treatment of essential IT expenditure and indirect costs.
- The deferral of depreciation revenue for SP Distribution until 2010 would be discriminatory as it would be inconsistent with Ofgem's well established precedent of dealing with the pre-vesting depreciation 'cliff-edge' when it occurs.

4.2 COST OF CAPITAL

4.2.1 The allowed cost of capital should be at least 5% fully post-tax, consistent with the top-end of Ofgem's range. We have consistently argued in our consultation responses that the cost of capital must be sufficient to allow companies to attract and retain equity funding and must take proper account of the increased uncertainty and risk to returns from exposure to incentive

regimes. The currently proposed figure of 4.6% post-tax does not adequately address these issues.

4.2.2 The industry has submitted empirical evidence that strongly supports a figure at the top-end of Ofgem's range. This evidence amounts to a very strong case in support of our position and we would request that Ofgem give proper consideration to this evidence prior to finalising its proposals.

4.2.3 In May, the Energy Networks Association (ENA) wrote to Ofgem in response to the March policy paper that the cost of capital should be at the top-end of the range and that anything other than this is low in comparison with Ofwat. Other ENA members had also sent two studies by OXERA and NERA, which pointed to a cost of capital at least at the top-end of this range. Also in May, NERA provided a report that looked at the cost of equity using the Dividend Growth Model.

4.2.4 In July, OXERA provided a report that compared the risks of the water companies and the DNOs and highlighted the new evidence that had emerged since the March policy paper that should have impacted Ofgem's proposed WACC range. Again this concluded that Ofgem should use the top-end of the range. Also in July, the ENA wrote again on this subject, to bring together six pieces of 'evidence' from the above work, relating to:

- City expectations that the outcome would be at the top end of the range;
- limited scope for out-performance during DPCR4;
- evidence from the NERA DGM work;
- comparisons with the water sector;
- increased uncertainty since the March policy paper; and
- embedded debt and equity issuance costs.

4.2.5 Historically, regulatory decisions have led to a flight from equity. We are very concerned that this will occur in the electricity sector, if Ofgem's figure is perceived as being too low by investors. Our investors believe that water provides the benchmark and a survey of investors undertaken by Water UK

(2004) found that nearly 70% of respondents thought the water industry was on a par or less risky than the electricity transmission and distribution companies.

4.2.6 Without sufficient incentive to invest in these businesses, government targets for renewables and the asset renewals programmes agreed with Ofgem could be severely impacted. We believe that the mid-point of the Ofgem range will not be sufficient to enable the industry to raise the necessary funding, especially when compared to the returns available to investors in other utility sectors, such as water or telecommunications.

4.2.7 Another area that we believe has not been fully considered is the impact of the incentive regime. Ofgem has proposed a significant strengthening of the incentive regime resulting in an increased revenue exposure and downside risk relative to upside potential. Both the level of risk that the DNOs will bear, which is much greater than in the water industry, and the asymmetric nature of the incentives suggests a cost of capital that is, in theory, greater than the figure for the water industry.

4.2.8 In its Summary of Responses to the Initial Proposals, Ofgem refers to a view expressed by one respondent that the Ofwat cost of capital might be driven by large capital programmes and persistent negative cash flows, and that these constraints will not exist for DNOs in the next price control period. Ofgem states that it sees merit in this view. However, as pointed out in our response to the Initial Proposals, analysis of Ofwat's recent draft proposals and comparison with Ofgem's latest proposals indicates that DNOs are, on average, expected to invest in proportionally more capital expenditure (relative to the RAV) during the next control period than water companies.

4.2.9 City analysts support our arguments that Ofgem's cost of capital assumptions are currently perceived as too far below those for the UK water companies. Investment bank Merrill Lynch is quoted in the press as saying:

'*In our view, 4.6 per cent is too low to fully incentivise investment in distribution networks and looks parsimonious relative to UK water*'.

4.2.10 Ofgem's mid-range figure is some 0.5% less than the figure of 5.1% fully post-tax proposed for water. The full extent of this gap cannot be justified when the electricity sector is seen as at least as risky as water. The allowed cost of capital should be at least at the top-end of Ofgem's range.

4.3 TREATMENT OF PENSION COSTS

4.3.1 We are pleased that Ofgem has recognised the costs of the Pensions deficit and specifically, has now accepted our position on the treatment of ERDCs. However some concerns remain with the modelling of the proposed allowance.

4.3.2 Within the September document, Ofgem states that it has disallowed "1/13 of the deficit to account for contributions made in 2004/5". This is of concern since SP Manweb expects to start deficit correction contributions from April 2005 and there is no allowance for deficit correction in the current price control. Spreading the remaining deficit over 13 years, rather than 12, from the start of the price control period compounds the issue further.

4.3.3 It is not appropriate for Ofgem to reduce pension deficits by 1/13th for 2004/5 contributions and we urge that this aspect of the pension calculations be amended accordingly in the Final Proposals.

4.4 TAXATION COSTS

4.4.1 We are pleased that Ofgem has revised its proposals in this area and is now using the same classification between operating costs and capital expenditure for tax purposes as is used in the price control calculations.

4.4.2 We note Ofgem's continued intention to introduce a new incentive and risk-sharing mechanism in the area of tax costs. No detail has been provided on the operation of such a mechanism and it is therefore entirely inappropriate for this to be introduced at this very late stage in the process.

4.5 RAV ROLL FORWARD

4.5.1 Ofgem's approach to the RAV roll-forward has resulted in excessive RAV deductions for our companies. Our major concerns relate to the treatment of essential IT expenditure and indirect costs.

Non - Operational Expenditure

4.5.2 Our letter of 21st July 2004 explained that we have incurred approximately £33m of necessary expenditure in excess of Ofgem's £30m opex allowance for IT costs during the current price control period. This letter requested that the excess expenditure be included in the RAV. These costs were incurred on systems that have provided direct customer benefits or were required to comply with regulatory requirements and also reflect our position on the IT investment cycle. We would reiterate our view that the excess expenditure should be incorporated in the RAV.

Indirect Costs

4.5.3 Ofgem's September update proposed a RAV deduction of £100m for our companies in relation to the treatment of indirect costs. This deduction is excessive and we believe that there is a strong case for a further £50m of

indirect costs to be added to the combined RAVs of SP Distribution and SP Manweb.

4.5.4 Our analysis indicates that we classify relatively more costs as indirect than other companies. This has not been taken into account by Ofgem but can be resolved by making a company specific adjustment for SP Distribution and SP Manweb in the classification of indirect costs to direct capital costs.

4.5.5 The RAV adjustments proposed by Ofgem were based on a benchmark level of indirect costs that could be included in the RAV. This benchmark was derived from 2000/01 data and the application of a bandwidth of +/-5%.

4.5.6 The decision to use 2000/01 data to determine the 'benchmark' level to be included in the RAV is arbitrary and the data used is incomplete and inconsistent. We support the use of a bandwidth but +/-5% is not sufficient to take account of the incomplete and non-normalised data. If Ofgem is to use 2000/01 data, then it must ensure that the data is complete and is normalised or it should increase the bandwidth. In our view, a bandwidth of +/-10% is necessary to take proper account of the data issues.

4.5.7 An alternative, pragmatic and more robust approach would be to base the benchmark on data from 2002/03 that Ofgem has normalised. In our view the industry average for capitalisation of indirect costs in 2002/03, combined with a bandwidth of +/-5%, is representative of the basis on which allowances were set. Although the level of capitalisation has increased across the industry, this is to be expected as companies move to 'catch up' with the basis on which the allowances were set.

4.6 FINANCIAL PROFILES – DEPRECIATION IN SP DISTRIBUTION

4.6.1 Although not included in the latest revenue proposals, we note that Ofgem is considering a major change to the treatment of depreciation for SP Distribution. In our view, it is not appropriate for Ofgem to introduce an issue with such a major impact on revenue at this very late stage in the consultation process. However, regardless of this significant process issue, we view the suggestion that depreciation revenue could be deferred until 2010 as discriminatory because it is inconsistent with Ofgem's well established precedent of dealing with the pre-vesting depreciation 'cliff-edge', when it occurs.

4.6.2 A more equitable approach of accelerating post-vesting depreciation to 15 years from 2010 with smoothing over 10 years would meet the objective of smoothing prices and would not discriminate against SP Distribution.

4.7 FINANCIAL MODEL

4.7.1 There remain two outstanding issues with the Ofgem financial model which we would urge Ofgem to correct ahead of the Final proposals:

- the incorrect use of a nominal rate of interest when determining the tax cash flows; and
- the incorrect use of a 20 year depreciation period for a number of companies, including SP Manweb, when calculating the revenue adjustments arising from the DPCR3 capex incentive.

4.7.2 In the price control allowed revenue calculation interest is determined using a real rate (currently set at 4.1%). However, in the determination of tax cash flows a nominal rate of interest (currently set at 6.7%) is used. For consistency, Ofgem's price control calculation should determine tax cash flows ignoring inflation, with all tax inputs including interest set in real terms.

4.7.3 The depreciation calculations in the capex incentive scheme model should reflect the depreciation assumptions in DPCR3 (i.e. this is a DPCR3 incentive which should not be affected by changes arising out of DPCR4) and ignore the smoothing approach effect in DPCR4 for 9 of the licencees, including SP Manweb.

SECTION 5: DISTRIBUTED GENERATION (DG)

5.1 SUMMARY

Our position on the various issues associated with this area of work is summarised below:

- the £/kW incentive rate requires to be updated for the base revenue year of 2005/06 and the revised assumptions on cost of capital;
- the allowance for operation and maintenance of Distributed Generation (DG) related assets should be increased to at least £1.5/kW;
- the arrangements for any network availability incentive must recognise that 100% availability is not appropriate for most distribution connections; and
- flexibility in treatment of generation under and over-recoveries will be required given the potential forecasting uncertainties and volatility surrounding DG revenues.

5.2 CONNECTION INCENTIVE

Incentive Rate

5.2.1 The £/kW incentive allowances have been set based on an assumed cost of capital of 6.5% pre-tax real. The figures will require to be updated to reflect the final position on cost of capital, including the treatment of tax.

O&M Allowance

5.2.2 We remain concerned that the proposed £1/kW allowance for operation and maintenance costs will be insufficient to cover the costs. This figure, which we understand was based on the lowest end of the aggregate range of company forecasts, is less than the figure estimated by Ofgem's consultants in this area, Mott MacDonald/British Power International. The consultants

stated that they regarded 1.3% per annum as reasonable and commented that there may well be additional operating costs associated with the introduction of active management techniques, resulting from a higher penetration of DG on DNO systems. Additionally, it was noted that some companies had under-estimated these additional costs.

5.2.3 On this basis, we believe the proposed £1/kW allowance will be insufficient to cover our costs relating to DG going forward. In line with the recommendation of its consultants, we would urge Ofgem to adopt an allowance for O&M of at least £1.5/kW.

Treatment of Capital Expenditure

5.2.4 As we understand it, DG related capital expenditure will not be included in the sliding scale mechanism. We would request written confirmation of this position.

5.3 NETWORK AVAILABILITY INCENTIVE

5.3.1 As set out in previous consultation responses, it is essential that any network availability incentive recognises that 100% network availability is not appropriate to distribution connections. We remain concerned that the use of a default interruption duration of zero will create an expectation that 100% availability is the norm. This will make it very difficult for a DNO to reach agreement with generators on a figure less than 100%.

5.4 OVER/UNDER RECOVERY

5.4.1 We note that a separate correction factor for generation-related distribution revenue has appeared in the draft licence modifications. Flexibility in treatment of generation under and over-recoveries will be required given the potential forecasting uncertainties and volatility surrounding the growth of DG revenues. There should be no possibility of financial penalty through the operation of any correction factor constraints relating to generation charges.

This could be achieved, for example, by removing any penalty rates on generation-related recovery positions for the next price control period.

SECTION 6: LICENCE AMENDMENTS

6.1 TARIFF BASKET WEIGHTS IN PRICE CONTROL

6.1.1 The Initial Proposals included new estimates made by Ofgem of tariff basket weights. Since that time each DNO has submitted to Ofgem illustrative DUoS tariffs and a revised DUoS charging methodology on which these are based. The methodology for SP Distribution and SP Manweb is intended to provide enhanced cost-reflectivity. The corresponding tariff basket values per unit are therefore more suitable as revised weights in the distribution price control. These are set out below.

	SP Distribution	SP Manweb
LV1 (p/kWh)	2.7442	1.8699
LV2 (p/kWh)	0.6794	0.6016
LV3 (p/kWh)	1.8388	1.4532
HV (p/kWh)	0.7426	0.6020

6.2 POLICY ISSUES RAISED BY LICENCE AMENDMENTS

6.2.1 We are concerned about a number of issues contained in draft licence modifications, some of which have been introduced with little or no prior consultation and which materially alter the principles and policies set out by Ofgem in the main consultation papers in March, June and September. It is important that these issues are addressed in a timely manner prior to Final Proposals being issued in November.

Recovery of Guaranteed Standards Payments Following Severe Weather Events

6.2.2 The latest draft licence modifications introduce a two-year delay into the recovery of severe weather payments. These payments could amount to several millions of pounds, per event, resulting in serious cash flow

implications given that two or more events could arise within the two-year period.

6.2.3 We see no reason to justify such a delay. The revised arrangements should be consistent with the current interim arrangements and adjust allowed revenue in the year in which the severe weather event occurs.

Provisions For Under-Recoveries

6.2.4 Draft Special Conditions E1 (4) and (5) restrict increases in DUoS charges (demand and generation respectively) where an under-recovery exceeds 4% of allowed revenue. This replaces the existing provisions which provide for regulatory intervention where an under-recovery exceeds 10%.

6.2.5 The case for this new clause has not been made, particularly given the new proposals for Guaranteed Standards payments following severe weather. DNOs may need to recover very substantial sums following such events. This is quite apart from other potential sources of variance from allowed revenue, such as losses and IIP. The threshold for intervention should remain at 10%.

Provisions for Changes to Allowed Loss Percentages

6.2.6 Draft licence modifications (special Condition C1, paragraph 6) currently provide for the allowed loss percentage to be revised up or down, without the consent of the licensee. This would involve significant regulatory risk for companies and it is therefore important that changes can only be made following full consultation with DNOs.