



SP Transmission & Distribution

Response to Ofgem Consultation Paper:

**Assessment of the Electricity Distribution Price Control Review
Process – March 2005**

20th May 2005

Members of the ScottishPower group

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EXECUTIVE SUMMARY

We believe that Ofgem is to be commended for delivering the Final Proposals for the recent Distribution Price Control Review (DPCR4) on schedule given the increased degree of complexity and changed business environment compared to previous reviews. However, we would make the following recommendations to ensure that future reviews are improved:

- **The specific requirements of individual companies and their customers should be given greater consideration.** This will ensure that the interests of customers in each company are best served by avoiding the imposition of a ‘one-size fits all’ approach.
- **Policy issues should be finalised as early as possible in the process and preferably before the publication of Initial Proposals.** This will ensure that there are no surprises in the later stages of the process and assist with the development of licence modifications.
- **Cost assessment methodologies, and associated models, should be developed and shared with companies as early as possible and in advance of the issue of the BPQs.** This will improve the cost assessment process, reduce the scope for misunderstandings and minimise wasted effort.
- **Information requests should be limited to those required to develop price control proposals.** This will ensure that the limited resources of both the companies and Ofgem are focussed on information that will have an impact on the final outcome.

We believe that sufficient consideration was not always given to our views, when these differed from the general industry view. Specific examples of this include our proposals to improve the supply quality of worst served customers and communities and our concerns relating to the DG incentive as applicable to SP Manweb. There is a need for these issues to be kept under review. **In the case of DG in SP Manweb, an urgent review of the incentive and other potential funding mechanisms is needed if the infrastructure required to support the plans of the Welsh Assembly for the development of renewable generation is to be delivered.**

Over the course of the review we endeavoured to work constructively with Ofgem to deliver an outcome that balanced the interests of customers, shareholders and other stakeholders. The comments contained in this response reflect our ongoing commitment to ensuring that implementation of the new price controls delivers such an outcome and that future price reviews benefit from the lessons learned during DPCR4. We trust that our comments will prove helpful in meeting these objectives.



INTRODUCTION

This is the response of SP Transmission and Distribution to the Ofgem consultation document of March 2005 entitled “Assessment of the Electricity Distribution Price Control Review Process”. The response document is split into two sections:

- Section 1, setting out our main recommendations aimed at ensuring that lessons learned from DPCR4 are acted upon, thereby improving the process associated with future price reviews; and
- Section 2, providing comments on the other issues raised by Ofgem’s consultation.



SECTION 1: RECOMMENDATIONS FOR IMPROVEMENT

1.1 Overall we believe that Ofgem is to be commended for delivering the Final Proposals for DPCR4 on schedule given the increased degree of complexity and changed business environment compared to previous reviews. However, we had some significant concerns with the process that were expressed in a number of our consultation responses. Based on these concerns we would make the following recommendations to ensure that major lessons to be learned from DPCR4 are acted upon, thereby improving the process associated with future price reviews:

- **The specific requirements of individual companies and their customers should be given greater consideration.** This will ensure that the interests of customers in each company are best served by avoiding the imposition of a ‘one-size fits all’ approach, for example in relation to worst served customers.
- **Policy issues should be finalised as early in the process as possible and preferably before the publication of Initial Proposals.** This will ensure that there are no surprises in the later stages of the process and assist with the development of licence modifications.
- **Cost assessment methodologies, and associated models, should be developed and shared with companies as early as possible and in advance of the issue of the BPQs.** This will improve the cost assessment process, reduce the scope for misunderstandings and minimise wasted effort.
- **Information requests should be limited to that which is required to develop its price control proposals.** This will help to ensure that the limited resources of both the companies and Ofgem are focussed on information that will have an impact on the final outcome.



- 1.2 Details of the specific concerns that have led us to make these recommendations are provided below.

Policy Issues

- 1.3 There were a number of major policy issues that were not finalised until a very late stage in the process. Aside from cost of capital, which Ofgem had consistently stated would not be finalised until the Final Proposals, these included the treatment of pre-vesting depreciation in Scotland, the treatment of overheads and cost efficiency incentives. As a result there was an unnecessary degree of uncertainty surrounding the final outcome.
- 1.4 In addition, there were a number of gaps in the detail of the policies set out in the Final Proposals such as the distributed generation (DG) incentive and Ofgem's proposals for managing cost uncertainty. This resulted in policy issues being debated after the publication of the Final Proposals and during the drafting of the final licence modifications. We were particularly concerned in the early stages of this process, when it appeared as if policy changes were being introduced that could have had a material effect on the proposals that had already been accepted.
- 1.5 It is therefore recommended that all significant policy issues be finalised at as early a stage in the process as possible and preferably before the publication of Initial Proposals. This should ensure that there are no surprises in the later stages of the process and will assist greatly with the onerous task of reflecting policy in licence modifications.
- 1.6 On the specific issue of cost of capital, as set out in our various consultation responses, we see no reason why the final figure cannot be confirmed prior to the Final Proposals. This would further reduce the amount of uncertainty surrounding the review outcome and enable companies to properly assess their cash flows and financial ratios.



Retrospective application of policy

1.7 A fundamental issue for future reviews will be to ensure that there is no retrospective regulation. During DPCR4 there were areas, such as the sliding scale mechanism and the rolling capex incentive from DPCR3, where it appeared that policy was applied retrospectively. In the case of the sliding scale mechanism, it was claimed that this provided companies with the choice between a lower capex allowance with 'higher powered' incentive or a higher capex allowance with 'lower powered' incentive. However, in practice, no such choice was available as the sliding scale incentive, which was predicated on variances between forecast capex and consultants' assessments, was introduced *after* companies had submitted their capex forecasts. In the case of the rolling capex incentive from DPCR3, Ofgem applied a different interpretation from what we believe was agreed at the time and applied this retrospectively.

Company Specific Issues

1.8 While there are a number of areas where it is appropriate to implement a common approach across all companies, there are other areas where issues specific to individual companies and their customers must be considered. We believe that there were a number of areas where our individual views did not receive appropriate consideration from Ofgem particularly when this differed from the majority view. Examples include:

- improving the supply quality experienced by 'worst served' customers and communities, where we presented strong arguments to support the need for expenditure to deliver such improvements and where discussions with customers and their representatives indicated a clear requirement and willingness to pay for such improvements;
- the DG incentive as applicable to SP Manweb, where we believe that we demonstrated at an early stage in the process that the incentive



mechanism did not fund the infrastructure required to support the plans of the Welsh Assembly for the development of renewable generation;

- our future investment requirements, where our assessment of these requirements, based on robust Asset Risk Management processes focused on the specific requirements of our networks, was considerably more robust than the high level assessment carried out by Ofgem and its consultants: and
- again on future investment requirements, a lack of recognition of network specific issues such as switchgear requirements in SP Manweb.

1.9 We therefore recommend that proper consideration be given to the specific requirements of companies and their customers at future reviews, particularly in relation to such issues as worst served customers. This will help to ensure that the interests of customers are best served by the outcome of the review.

Early Development of Cost Assessment Models

1.10 It is important that the criteria by which costs will be assessed during the review process is clearly understood by all prior to completion of Business Plan Questionnaires (BPQs). In this regard it is essential that companies have access to the models that will be used and that they are informed at an early stage in the process of all aspects that will be taken into account.

1.11 During DPCR4 Ofgem developed its cost assessment models in parallel and, in some cases after, the submission of the BPQs. This led to a number of misunderstandings around the data submitted by companies and, in the case of capex, conflicts between the outputs of the model used by Ofgem's consultants and the outputs from our own models.

1.12 We therefore recommend that Ofgem's cost assessment methodologies, and the associated models, are developed as early as possible, in consultation with companies, and in advance of the issue of the various BPQs and are shared



with companies. This will improve the cost assessment process, reduce the scope for misunderstandings and minimise wasted effort.

Ofgem's Information Requirements

- 1.13 We believe that there were a number of areas where Ofgem did not use all of the information that it requested from companies. Examples of this include the DNO Alternative scenario and the numerous quality of supply scenarios and sensitivities for the Forecast Business Plan Questionnaire (FBPQ). Significant effort was involved in preparing these submissions but little use appeared to be made of this information by Ofgem.
- 1.14 We therefore recommend that Ofgem endeavours to limit the information that it requires from companies to that which is required to develop its proposals. This will ensure that the limited resources of both the companies and Ofgem are focussed on the preparation and analysis of information that will have an impact on the final outcome. While we appreciate that it is not always possible to anticipate exactly what information will be required, implementation of the previous recommendation relating to the early development of cost assessment models would assist greatly with this.



SECTION 2: OTHER ISSUES

2.1 This section provides comment on those issues that are not dealt with in Section 1 of the response document.

Need for Independent Review

2.2 Throughout DPCR4 our consultation responses referred to the need for an independent review of the process. We continue to believe that it is not appropriate for Ofgem to review its own process and that an independent body reporting to the Authority should have conducted the process review, informed by comments from all interested parties, including Ofgem. We believe that by not implementing an independent review, Ofgem has missed an opportunity to ensure that all stakeholders obtain maximum benefit from this exercise.

DNO/Ofgem Working Groups

2.3 We remain very supportive of the use of Ofgem/DNO working groups and were pleased to provide a number of our key staff to participate in these groups. However, it appeared as if Ofgem was placing less priority on some of these groups as the price review process progressed. Cancellation of a number of scheduled meetings during 2004 is, we believe, indicative of this change in priorities.

2.4 Ofgem/DNO working groups can have a major role in the price review. We would urge Ofgem to continue to use such groups in future price reviews but to actively engage in such groups at least until all policy issues are finalised and give proper consideration to their recommendations.

Preparatory Work

2.5 We welcome the increased level of preparatory work that was carried out prior to DPCR4 compared to previous price reviews. However, there were



no firm conclusions from the Network Monopoly Price Control project and we believe that the time and resources that were expended on this project could have been used more effectively. Areas that could have benefited from further time and resources include the cost assessment methodology and the DG incentive.

Use of Consultants

2.6 Our main comment relates to the limited use of external consultants in the assessment of future capital expenditure requirements and to the very opaque nature of the analysis. Ofgem adopted a ‘one size fits all’ approach, with inadequate technical input from external consultants. This contrasted with the detailed approach used us in developing our own investment requirements, derived from robust Asset Risk Management processes which had been assessed by Ofgem as leading class, focused on the specific requirements of our asset base.

2.7 In assessing investment requirements in future price reviews, Ofgem should give proper consideration to the specific requirements of each company’s asset base. This will require either a greater use of Ofgem’s in-house technical resources or increased use of external consultants when compared to DPCR4. In addition, Ofgem’s assessment of the Asset Risk Management policies and practices of companies should be linked with the price review. This assessment requires a significant resource from companies but is of little value if, as appeared to be the case in DPCR4, it is not used to inform the price review analysis.

Consultation Process

2.8 The number of consultations was ‘about right’ and the response periods specified were sufficient. We would not support any reduction in the number of consultations as this would significantly reduce the transparency of the process.



- 2.9 We found it particularly useful to be able to comment privately on Ofgem's emerging views in advance of the Initial Proposals (via our response to Ofgem's April letter of 2004) and in advance of the Final Proposals (via our 'short-form' response to the update paper of September 2004). We would strongly support the use of such 'confidential' consultations at similar stages of future price reviews.
- 2.10 As set out in Section 1 of this response document, we are concerned that sufficient consideration was not always given to our views when these differed from the general industry view. We believe that Ofgem's consultation documents did not make the case for the rejection of our views in these important areas.

Timeline

- 2.11 The publication of the DPCR timetable at an early stage in the process was extremely useful in assisting with resource planning. In future price reviews we would welcome the publication of a timetable as early as possible. Given that the preparation of the various Business Plan Questionnaires (BPQ) is one of the most resource intensive activities from the company perspective, it would be helpful if the timetable for BPQ submission could be made available at least 6 months in advance of BPQ publication.

Transparency

- 2.12 We comment on the lack of transparency in the capex assessment in paragraph 2.6 of this response document. However we believe that the processes and analyses around the other aspects of costs assessment were sufficiently transparent. In particular, we consistently supported the publication of appropriate data to inform the price review process. However in assessing the issue of data publication in future reviews we would emphasise that data should only be published if it is relevant, accurate, comparable and complete, and that reasonable concerns regarding commercial confidentiality are addressed. The publication of any data that



does not pass these tests will not assist with a transparent price review process and could result in major stakeholders, including city analysts and major investors, drawing erroneous conclusions.

- 2.13 In addition, the commercial interests of companies must not be adversely impacted by the publication of detailed data on costs and expenditure. If such data were to be available to suppliers of goods and services then it could seriously prejudice our ability to procure these goods and services at competitive rates. Furthermore, detail on expenditure in competitive areas must not be published as this could seriously and prejudicially impact our ability to compete in these areas.
- 2.14 Where Ofgem proposes to publish information then companies must be given sufficient opportunity to provide comments and to discuss these comments with Ofgem prior to publication.

Access to Ofgem and the Authority

- 2.15 In general, we were satisfied with the access that we were provided to the Authority and to Ofgem staff at various levels. However we became concerned following the publication of the September 2004 update document that access to Ofgem senior management was very limited when there were major policy issues, such as pre-vesting depreciation for the Scottish companies that had not yet been finalised. This situation was not satisfactory and can be avoided in the future by ensuring that all major policy issues are finalised prior to the publication of Initial Proposals.