
# Response to Ofgem September 2006 Consultation

# Transmission Price Control Review: Updated Proposals

# Ref: 170/06

## 24 October 2006

Members of the ScottishPower group

New Alderston House Dove Wynd Strathclyde Business Park Bellshill ML4 3FF
Telephone (01698) 413000 Fax (01698) 413053

# SP Transmission Response to September 2006 Consultation on Updated Proposals for the Transmission Price Control Review

## Executive Summary

Although these updated proposals show some positive progress since the Initial Proposals, they still do not adequately address the level of risk and uncertainty faced by SP Transmission Limited ("SPTL"). Four key areas must be addressed:

- Our cost of capital must be sufficient to ensure that we are able to finance our business effectively, retaining and attracting existing equity, at a time when significant investment is required to meet the government's targets for renewables and to ensure security of supply.

- The significant risk of inflationary pressure on input prices must be adequately addressed and the arbitrary procurement efficiencies proposed by Ofgem should not be imposed.

- The baseline capital expenditure allowance for local connection works must be increased to take into account projects that are likely to connect over the next price control period. Further, the revenue drivers for investment beyond this baseline must be based on more realistic assumptions.

- Our Dewar Place project must be adequately funded.

## Cost of Capital

We are very concerned by Ofgem's Initial Proposals that imply an allowed return of 4.2% post tax real compared with the 4.8% set for the DNOs, based on extensive analysis and consultation less than two years ago.

In our view, the proposed cost of equity of 7% would be insufficient to attract the equity needed to fund our vital investment programme, particularly in competition with other higher return/lower risk infrastructure investment opportunities. SPTL's allowed cost of equity should be at least 7.5%, which is the level that we believe is needed to provide a fair return on existing equity invested and to provide sufficient incentive to attract the required new equity.

Similarly, the proposed cost of debt of 3.4% would leave us with a serious negative mark-to-market on our existing debt portfolio, some of which we locked in following Ofgem's decision in setting the allowed cost of debt at 4.2% in DPCR4. It will also be extremely challenging to raise debt at this cost given the upward pressures on interest rates and the downward pressure on our A rating stemming from increased gearing and increased cashflow risk. SPTL's allowed cost of debt should be at least 4.2% real, which we believe would be the interest costs prudently incurred in the management and financing of a long-life asset business such as SPTL.

In conclusion, we believe that SPTL's allowed weighted average cost of capital should be at least 4.8% post tax real as set in DPCR4, a view strongly supported by our financial advisors and investors. We should also add that significant changes in the allowed cost of capital between DPCR4 and TPCR4, with less than two years lapsed since DPCR4 was concluded, would materially undermine equity and debt investors' confidence in the regulatory regime and would, in itself, increase the cost of capital.

## Input Cost Increases

We all acknowledge that the industry faces unprecedented increases in input prices linked to a number of factors. Ofgem's proposal to address input cost increases through a 5% increase in SPTL's ex-ante baseline allowance is insufficient. We require a 22% increase in our ex-ante baseline allowance to address input cost increases.

## Procurement Efficiencies

Ofgem's proposals are built on inappropriate analysis drawn from consideration of NGET's procurement practices. Against the background of input cost increases and efficiencies already built into our business plan submission, there is no justification to reduce our allowances on the basis of procurement efficiencies.

## Load Related Investment

Load related investment is inherently higher risk than non-load related and SPTL require a risk premium of at least 1% (i.e. offering an enhanced expected return of at least 7.9% pre-tax real) and to ensure adequate financeability, a floor on the return of at least 6.9% pre-tax real.

***Revenue Drivers – local works:*** We require a minimum ex ante baseline allowance for local infrastructure works of at least £110m to connect 1734MW. For investment above the baseline level, we require a revenue driver of at least £63.50 per kW. The timing of revenues must ensure financeability and the financing costs associated with any lag between capex and associated revenues must be fully funded.

***Revenue Drivers – deep reinforcement:*** We require an ex-ante baseline allowance of £153M that is NOT contingent on triggers

***New connections below 100MW***: We require a mechanism to provide additional funding in the event that developers insist on a "firm" connection in-line with current contractual commitments.

## Non-Load Related Investment

***Dewar Place:*** Our Dewar Place refurbishment project is unique and our proposal is the most economic and viable solution for this site. We require full funding for Dewar Place.

***Overhead Lines:*** Although we welcome the additional funding provided by Ofgem for overhead lines, the allowance provided is an 11% reduction on our requirements. This resulting deferral in investment will increase risk to network security and create

further challenges as a consequence of network access constraints and the deliverability "cliff face" in future price control periods.

***BT 21st Century:*** We are concerned at the suggestion in the latest proposals that funding for BT 21st Century may be deferred until the next control period. A re-opener is required.

## Controllable Operating Costs

Although our controllable operating cost allowance has increased by £4.3M, it still represents a reduction of £14.3m (15%) from our requirements. This reduction will lead to the cancellation of our tower painting programme, and a reduction in the scope of our substation maintenance programme.

## Incentive Arrangements

***Capital Expenditure Incentive Mechanism:*** In the current supplier driven marketplace, in which we are facing exceptional cost increases, we face being penalised for potential overspends over which we have no control. In such an environment an efficiency incentive of the order of 25% would appear to be appropriate combined with a rolling mechanism to address the distorting effect arising from periodicity.

We do not agree that it is necessary to introduce a 20% cumulative underspend trigger. If there must be an incentive of this nature, then we recommend it is applied to non-load related investment only, with a higher threshold that is licensee specific. We do not believe that an automatic adjustment mechanism would be appropriate.

***Innovation Funding Incentive:*** Ofgem's price control calculations are based on 0.4% of price control revenue. A 0.4% revenue cap is insufficient. We require a 1% revenue cap upper ceiling.

***Network Incentive Regime:*** The network incentive regime proposed by Ofgem is not a true incentive if it is to be penalties only. A symmetrical rewards and penalties regime is required.

## Sustainable Development And The Environment

***SF6 Incentive:*** If incentive arrangements are to be introduced for SF6 emissions then we recommend a % leakage rate over a 5-year incentive period. Due to design constraints, different types of SF6 asset classes will have different leakage rates and it may be necessary to design incentive arrangements that take this into account.

***Visual Amenity:*** As the scale of transmission projects is much larger and higher cost than distribution, we accept that decisions affecting visual amenity (i.e. projects requiring undergrounding) are best assessed on a case-by-case basis. In the event that it is necessary to change the scope of any of our deep reinforcement projects to include undergrounding then, due to the very high additional costs involved, we would expect this to be taken into account through an increased allowance.

## Financial

***Accelerated Depreciation:*** We welcome Ofgem's accelerated depreciation proposals however these proposals should be extended to the England-Scotland Interconnector and pre-BETTA connections (PLUGs) assets.

# SP Transmission Response to September 2006 Consultation on Updated Proposals for the Transmission Price Control Review

## Table of Contents

# 1. Cost of Capital

For modeling purposes, and to provide a reference point for consultation responses, Ofgem have retained the modeling assumption from the June Initial Proposals of a real post tax return of 4.2%. This allowed return is well below the level required to adequately finance our activities. It is notable that responses to Ofgem's Initial Proposals were dominated by the transmission companies and financial institutions arguing that a post-tax real rate of return of 4.2% is too low.

In July we submitted a detailed paper to Ofgem on the cost of capital in which we explained that we would have to fund a substantial capital investment programme over the five-year price control period. This large programme will increase business risk, which will raise both the cost of equity and the cost of debt. Associated with this response, we are submitting a further paper which sets out our case on the cost of capital in more detail.

***Cost of Equity and Equity Beta***

To fund our capital investment programme, we need to retain the capability to attract and retain equity funding. This requires the cost of equity to be sufficient to compensate shareholders for the increasing risk which they will bear. SPTL is competing to raise funds with an abundance of attractive infrastructure sectors which offer higher returns. We are concerned that any departure from the approach and assumptions used in DPCR4 to assess the cost of equity carries a high risk that investors will reallocate investment away from SPTL.

The cost of equity has not declined since DPCR4 and the estimated historic beta factor for ScottishPower is at its highest since 1999, above that observed when the cost of capital for DPCR4 was set, and continues on a rising trend. The systematic risk factor, equity beta, on a forward-looking basis should not be less than one.

Importantly, there are systematic risk differentials (set out below) between SPTL and NGET. Therefore these differentials should continue to be reflected in a higher cost of equity for SPTL.

***Dividend Discount Model***

In view of the difficulty of obtaining precise estimates of the cost of equity for utility companies, using the CAPM, a cross-check should be used. The most widely used alternative approach to the CAPM is the dividend discount model. Assuming that the IBES consensus forecast of 8.7% nominal growth, for a range of network utilities[1], will last for five years and dividend growth of 2% in real terms, thereafter, when combined with the average dividend yield of 4%, implies a cost of equity of around 7.5%, in real terms.

[1] ScottishPower, Scottish and Southern, National Grid, United Utilities, Viridian, Kelda and Seven Trent

***Costs of Equity Issuance***
Allowance must also be made for the costs of equity issuance with 50 to 80 basis points included to finance our growing investment programme.

***Allowed Cost of Equity***
We therefore require an allowed cost of equity of at least 7.5% to ensure a fair return on existing equity and provide sufficient incentive to attract new equity.

***Cost of Debt***
It would be inefficient to pre-fund the large capital expenditure programme in an attempt to lock into current interest rates, which are expected to rise in future. SPTL has a portfolio of debt which was efficiently financed at the time through a rolling programme. It is unrealistic to expect us to refinance this at current interest rates without incurring substantial costs. The cost of debt should reflect the long run historic average for debt of the corresponding credit rating implied by Ofgem's financial modelling, which is currently BBB. There is persuasive evidence that institutional factors, particularly relating to pensions, have distorted the yields on UK index-linked gilts and the underlying risk free rate has not declined since DPCR4. Furthermore, the debt premium will rise if SPTL is unable to maintain its A-credit rating. Overall, the allowed cost of debt should be at least 4.2% reflecting the long run historic average.

***Relative Risk***
SPTL is small scale, with limited geographical coverage, and is more like a regional distributor, with an extensive 132kV network. It is important to recognise this and address the fact that SPTL faces as much systematic risk as the DNOs, and faces more risk than NGET, based on the evidence of a range of drivers of systematic risk. Specifically, SPTL has comparable financial gearing and higher operational leverage than a number of its peers in electricity transmission and distribution.

The relative systematic risk of SPTL is corroborated by historically higher equity and asset betas when compared with National Grid, SSE, and other electricity distribution companies. Operational leverage (ratio of fixed to total costs) is higher than NGET and is increasing.

In addition, it is important to take into account other factors being proposed by Ofgem which will impact on systematic risk, including revenue drivers, input cost increases and the penalty-only regime for network performance. For revenue drivers, we are particularly concerned that Ofgem underestimate the value of any revenue driver, leading to substantially weakened investment incentives.

SPTL is smaller and more geographically focused than NGET, which may be expected to have an impact on the cost of debt. Other things being equal, the smaller the size of operations, the greater is the risk that sustained downturns in the macroeconomic environment will result in financial distress. Similarly, SPTL is more exposed to downturns in the regional economy.

***Risk Free Rate***

Our analysis indicates that the underlying risk free rate has not changed significantly since DPCR4. We strongly recommend that Ofgem should adopt a cautious assessment of the risk free rate, reflecting the long-run average yield and taking account of higher international index-linked yields, a typical (positive) term premium and rising short term interest rates.

***Smithers & Co Report on Cost of Capital***

The Smithers & Co report on cost of capital attempts to justify a reduction in the cost of equity rather than assess the true forward looking risks faced by the transmission companies. The conclusions on the cost of equity in this report are flawed.

One fundamental issue is the evidence from energy groups does not support the equity beta of 0.5. The pooled beta estimates are biased downwards by the inclusion of the particularly low estimated betas for Kelda and Seven Trent but these are water and sewerage companies with lower systematic risk than energy companies.

Smithers assertion that "higher gearing appears to be associated with lower equity beta" is seriously flawed. In accordance with standard finance theory, historic estimates of beta need to be re-levered to reflect the increase in gearing to 60% which Ofgem propose. It is not correct to combine historic estimates of beta, which reflect historic gearing levels, with a higher hypothetical level of gearing. To disregard this basic adjustment would be completely unjustified and seriously underestimate the cost of equity. For example, assuming a historic equity beta of 0.65 and actual gearing of 31% would result in a re-levered beta of 1.12 for gearing of 60%.

***SPTL Requirements***

Our analysis supports an allowed return of at least 4.8% (fully post tax real) for SPTL as a small stand alone entity, having to raise funds when higher returns are available in many other infrastructure sectors, including water and transport.

# 2. Load Related Expenditure

SPTL faces considerable uncertainty and risk regarding the level and timing of load related expenditure. Anticipated expenditure during the period represents a substantial proportion of RAV, which serves to increase operational leverage (i.e. the ratio of fixed to total costs). Ofgem's current proposals for revenue drivers will delay receipt of associated revenues and will have an adverse impact on financeability. Consequently, load related investment is inherently higher risk than non-load related and SPTL require a risk premium of at least 1% (i.e. offering an enhanced expected return of at least 7.9% pre-tax real) and to ensure adequate financeability, a floor on the return of at least 6.9% pre-tax real.

We note that table 9.1 titled 'Baseline capex allowance for new generation connections, SPTL and SHETL' on page 50 of the proposals is incorrectly titled and incorrectly positioned in the Local Connection Costs section.

This table shows a baseline capex of £289m for SPTL, however this baseline capex includes a number of categories including Deep Reinforcement, Local Works, and Demand Connections.

The baseline capex currently proposed by PB Power and Ofgem for local connection works for 1734 MW is £75m.

## 2.1 Deep Reinforcement

The deep reinforcement baseline projects total £153m and include the Scotland-England interconnector reinforcement and six shared infrastructure projects (collectors). Ofgem's consultants PB Power have confirmed that the interconnector is non-compliant with network security standards and the upgrade is economically justified regardless of whether any additional generation is connected during the period. Construction of the collectors will be necessary to meet the commitment to connect 1734 MW and to avoid inefficient "piecemeal" development of our network and potential delays to connection projects. It is therefore not necessary or appropriate for these deep reinforcement projects to be dependant on "triggers". To do so would introduce further uncertainty and risk for our business and will have an adverse impact on overall financeability.

We recognise that there are an additional number of lower probability deep reinforcement projects that may be necessary during the price control period. However, the design and scope of these projects is currently at an outline level of detail and as such it is inappropriate to assign a fixed £m cost and scope at this stage. We believe that when appropriate triggers have been met, a review process should be followed to agree the detailed project scope, cost and associated revenues.

Should Ofgem's current proposals be implemented, it is inappropriate for SPTL to face the risk of under-funding for these projects and a mechanism for ex-post full truing up of future revenues based on actual capex should be implemented.

## 2.2 Revenue Drivers – Local works

We recognise that cost reflective revenue drivers can help to mitigate the impact of uncertainty surrounding future requirements. However, while accurate and robust revenue drivers may provide protection to customers, revenue drivers that are not cost-reflective may represent greater risk to customers than a fixed allowance. Consequently any revenue driver implemented must have a high likelihood of delivering appropriate revenues for all probable scenarios.

***Baseline Allowance***

Our original business plan assumption was based on 2047MW of generation connecting during the next Price Control period and was consistent with GBSO planning assumptions. We acknowledge that the actual MW that will connect is subject to some uncertainty and consequently we would be prepared to accept Ofgem's request for a commitment based on 1734MW.

We also recognise that PB Power's methodology is a reasonable approach to high-level modelling of capital expenditure requirements. However the dataset used by PB Power was incomplete since it was based on the subset of "high probability" projects within our business plan, current at the time the plan was submitted, rather than the full range of connection offers. Our analysis based on the full dataset of connection offers demonstrates that the £75m baseline allowance currently proposed by Ofgem is 90% likely to be insufficient to connect 1734 MW.

In order to complete a statistically robust analysis, PB Power should have considered the full dataset of connection offers. Our analysis based on PB Power's methodology using a more appropriate dataset (incorporating a realistic assessment of projects most likely to proceed and excluding statistical "outliers") of connection offers demonstrates that at least £110m will be required to connect 1734MW. It should be noted that an increased baseline allowance of £110m still presents significant risk and is only 50% likely to be sufficient.

We understand that Ofgem are proposing to manage "sample risk" associated with the baseline by limiting the difference between actual capital costs and allowed capital costs through a one-off adjustment once the specified volume of MW has been met. It is important that this adjustment mechanism provides an appropriate balance between incentives for efficiency and out-performance whilst not exposing SPTL to excessive risk. In this context, Ofgem need to consider the timing of the one-off adjustment and the extent to which SPTL are allowed to recover revenues associated with the difference in costs. In order to avoid potentially significant financeability issues arising from the lag between capex and associated revenues, SPTL believe that an initial adjustment should be made at the time that 1734MW of generator connections have satisfied User Commitment, on the basis of the projected costs of those particular connections, with a further adjustment based on actual costs following the completion of the connections. In order to mitigate risk of inadequate returns, SPTL

believe that a cap and floor on the difference between costs and revenues should be set at plus/minus 7.5% rather than the 15% currently proposed by Ofgem.

Ofgem need to carefully consider the interaction between this revenue adjustment mechanism and the 25% capital efficiency incentive. We are assuming that this will be implemented in a manner that ensures that SPTL will receive full true-up of costs and revenues for expenditure outside the cap and collar threshold. We would expect the capital efficiency incentive to limit our exposure to 25% of the cost of expenditure in excess of the baseline allowance for expenditure within the threshold.

***Funding for Existing Contractual Commitment***

Ofgem have assumed that developers of connections of less than 100MW generators will respond to the GBSO's proposed new incentive arrangements to accept lower cost "non-firm" connections and have reduced our capex allowance accordingly. However it is unlikely that all developers will respond to this incentive and some are likely to insist that we deliver the more costly "firm" connections that we are currently contractually committed to provide. A mechanism is required to provide additional funding in the event that developers insist on a "firm" connection.

***Revenue for Work over Baseline***

Ofgem are proposing that funding for connecting MW over and above the specified baseline level will be provided through a revenue driver mechanism. Ofgem's proposal that revenues should be triggered after SPTL has incurred 25% of project costs is inappropriate and will adversely affect risk and financeability. This is further compounded by the fact that only 75% of revenues are passed through on an "as incurred" basis via the revenue driver with 25% withheld until project completion. We believe that revenues for projects over baseline should be triggered immediately upon acceptance of User commitment and provided on an "as incurred" basis.

Ofgem suggest an (illustrative) local connection revenue driver of £42.90 per kW, based on the same PB Power analysis that was used to derive a baseline capex allowance of £75m for the local works required to deliver 1734MW. As explained previously, this analysis was based on an incomplete dataset. Using the more appropriate dataset used to derive a requirement for £110m to deliver 1734 MW, implies that a local connection revenue driver of at least £63.50 per kW is necessary.

Ofgem have acknowledged that SPTL are also exposed to a "sample risk" that the £ per kW revenue driver may be insufficient to fund the 25% of the costs of projects above the baseline that are subject to this driver. We believe that this risk can be partly addressed by applying a cap and floor on the difference between costs and revenues of plus/minus 7.5% rather than the 15% currently proposed by Ofgem with full true-up of costs and revenues for expenditure outside the cap and collar threshold. We would expect the capital efficiency incentive to limit our exposure to 25% of the cost for expenditure within the threshold. The financing costs associated with the inherent lag between capex and associated revenues in the proposed revenue driver mechanism should also be fully funded.

# 3. Non-Load Related Expenditure

***Dewar Place***

We still have a major funding gap of £28m covering our refurbishment plans for Dewar Place in Edinburgh (and we are disappointed that there is no acknowledgement in the September Update that further consideration of Dewar Place will be undertaken by Ofgem). Dewar Place is a unique site and it is essential that full funding is provided.

***Overhead Lines***

Although we welcome the additional funding provided by Ofgem for overhead lines, the allowance provided is an 11% reduction on our requirements. This resulting deferral in investment will increase risk to network security and create further challenges as a consequence of network access constraints and the deliverability "cliff face" in future price control periods.

***BT 21st Century***

We stated in our response to Ofgem's Initial Proposals that although we would have preferred funding that addresses the BT21st Century issue to form part of the baseline, we believe the principle of a re-opener could work. We still believe that we will be required to invest during TPCR4 and so we are concerned at the suggestion in the latest proposals that funding may be deferred until the next control period. A re-opener is required.

***Non-Operational Capital Expenditure***

We disagree with Ofgem's view that non-operational capital expenditure should be treated as operating expenditure. Consistent with the treatment in DPCR4, non-operational capex should be separately identified and included in the RAV. In order to increase the transparency of regulation, we believe that there is a strong argument to, as closely as possible, align RAV additions with fixed asset additions as required by applicable accounting standards and reported within the Statutory and Regulatory Accounts. Any published performance comparatives will lose credibility if an opex variance is attributed to, for example, unanticipated IT investment or depot refurbishment.

# 4. Input Cost Increases

SPTL has seen unprecedented increases in input prices, linked to a number of factors. Demand for raw materials worldwide is continuing to drive costs well above RPI and over the last year we have seen project tender prices increasing by 10% to 55%. We forecast tender prices continuing to increase well above RPI as a result of various factors including a reduction in global manufacturing, the forecast growth in India and China, the future impact of London Olympic Games construction work in civil engineering and an overall hardening of the supply market.

We have consistently expressed our concerns over rising input prices and, until this September Update paper, Ofgem had not given any indication as to how this would be resolved. Insufficient funding to address input price rises over the price control period, may necessitate a scaling back of our investment programme leading to increased network risk as our asset base ages.

Ofgem are currently proposing a 5% (£28m) increase to our baseline load and non-load capital expenditure allowance to accommodate increases in input prices. This allowance is unlikely to be sufficient and Ofgem's analysis, which is based on consideration of raw material costs alone, uses out of date raw material cost forecasts and does not take account of the wider supply market issues. Observed increases in real tender prices are significantly greater than would be implied by raw material cost increases.

Ofgem's consultants PB Power, have concluded *"all the indices reviewed are rising faster than RPI. In particular the BEAMA (overall electrical cost) indices show sharp rises…". "…recent prices for the supply of transformers and cables as well as installation and project management are showing noticeable increases…."*

Taking into account up-to-date raw material cost forecasts and considering recent tender price trends suggest an increase in the ex-ante baseline allowance of at least 22% is necessary.

# 5. Procurement Efficiencies

We have already included the maximum achievable efficiencies within our business plan submission and against the background of increasing input prices, the further reduction of 5% proposed by Ofgem amounts to double counting and is not achievable.

Ofgem's proposals are built on inappropriate analysis drawn from consideration of NGET's procurement practices. We can see no basis for this reduction as Ofgem has not undertaken a detailed analysis of our procurement practices during this Price Control Review or provided any justification for the proposed reduction. During the last Distribution Price Control Review, Ofgem's consultant Ernst & Young completed a detailed review of our procurement practices and found procurement was an area of strength, *"well thought out and progressive" with "evidence of best practice"*.

We have taken all practicable measures to maximise procurement efficiencies. As we have explained to Ofgem and their consultants, our procurement strategy has been developed to support delivery of our capital investment programme. Central to this strategy is our partnership approach developed over the last five to six years with key strategic suppliers and contractors. This includes framework agreements for both the purchase of equipment and the provision of contractors to deliver turnkey construction solutions. It also involves standardising our requirements and developing new sources of supply and products. Also, as a matter of course, we go to international markets to achieve best value for money and can cite examples of contracts placed with international suppliers.

# 6. Incentive Arrangements

***Capital Expenditure Incentive***
Ofgem are proposing a relatively shallow capital efficiency incentive of 25% (of similar magnitude to SP Distribution and SP Manweb). The incentive regime is designed to reward or penalize the companies depending on whether they spend less or more than the allowances that have been set. This transmission price control review sees major increases in capital expenditure requirements along with the potential for unprecedented input price rises. We have already expressed our view that there is limited if any potential to make any efficiencies and there is a significant risk in the present supplier driven market that our business could face overspends that are outwith our control. In such an environment an efficiency incentive of the order of 25% would appear to be appropriate combined with a rolling mechanism to address the distorting effect arising from periodicity.

We do not agree that it is necessary to introduce a 20% cumulative underspend trigger. If there must be an incentive of this nature, then we recommend it is applied to non-load related investment only, with a higher threshold that is licensee specific to take into account the fact that transmission projects are lumpy and individual projects represent a large percentage of the annual programme for SPTL.

We do not believe that an automatic adjustment mechanism would be appropriate. We suggest that in the event of an underspend in excess of the trigger level, the annual Regulatory Reporting Pack (RRP) review process would provide adequate opportunity for Ofgem to examine reasons for the underspend.

***Innovation Funding Incentive***
Although Ofgem states that the parameters of the IFI scheme are not yet decided, the price control calculations in Appendix 6 are based on 0.4% of price control revenue. This is less than the 0.5% allowance in Ofgem's Initial Proposals and also applied to the DNO's from the Distribution Price Review. In our view a 0.4% revenue cap is insufficient. By applying a 0.4% revenue cap on IFI expenditure, SPTL will receive around £600k p.a. as compared with the average IFI cap for a UK DNO licence of £1.2m.[2] The impact of the application of a 0.4% turnover cap on SPTL IFI would severely limit the number of projects that could be undertaken for the following reasons:

- The complex nature of transmission R&D projects together with the need to manage risk associated with implementation trials generally leads to greater project costs than similar Distribution projects.
- All three transmission licence areas have similar issues associated with ageing assets, optimal network reinforcement, environmental impact, etc. that would potentially benefit from R&D. At a 0.4% turnover cap, the budget of SPTL would

[2] From the 2005/06 IFI Annual Report submissions,

be less than 15% of that allowed for NGET and will significantly limit the development activity that could be undertaken beyond the first couple of years (while the programme is building).

As we recommended in our response to Ofgem's Initial Proposals, we require a 1% revenue cap on IFI expenditure.

***Network Performance***

We note that Ofgem still proposes a penalties only network performance regime. The move to a minimum standard reliability incentive, i.e. a 'penalties only' scheme, is disappointing and not a true incentive. We recommend that any network incentives should be symmetric i.e. penalties and rewards, and entirely within the control of the TO with observable metrics.

***Transmission Connections to the Scottish Islands***

As we noted in our earlier response to the Initial Proposals, we support extending competition to these connections and would be very interested in participating in a competitive process.

# 7. Operating Expenditure

In setting our operating costs, our strategy is to comply with legal and licence obligations whilst safeguarding our staff and the public from hazards and minimising the risk of asset failure. Although Ofgem has increased our controllable operating cost allowance by £4.3M from the Initial Proposals, the proposed allowance still represents a reduction of £14.3M (15%) from our requirements. This reduction means that we will be unable to undertake our planned tower painting programme necessary to ensure that these important assets achieve their design life expectancy. In addition a 12% reduction in substation maintenance activity will be necessary with an associated increased risk to the safety and integrity of our network.

Ofgem have not allowed for the fact that our growing asset base, for example due to renewables, will immediately incur additional costs for statutory and safety inspections and, in the longer term as the assets become due for periodic maintenance, additional maintenance costs. Nor have Ofgem provided sufficient account of the increased costs associated with an ageing asset base e.g. increased requirement for hazard and defect rectification.

# 8. Financial Issues

***Accelerated Depreciation***

We welcome Ofgem's proposals in respect of accelerated depreciation and consistency with the treatment in DPCR3 and DPCR4. This will help to ensure price stability and mitigate against the short-term financial impact on companies that would otherwise result.

We have reviewed the Financial Modelling of accelerated depreciation and note that accelerated lives/smoothing have not been applied to the England-Scotland Interconnector and Pre-BETTA connections (PLUGS) assets. These assets are also "post-Vesting regulatory assets" and therefore we believe the accelerated lives/smoothing proposals should apply.

***Pensions***

*Past over/under funding*

We are in agreement with the position taken within the September update which is that Ofgem do not intend to attempt to make any adjustment for over or under-funding other than for NGG in the period 2002-2007.

*ERDCs*

We acknowledge Ofgem's amended proposals in respect of ERDCs. However, in principle we believe that there should be no distinction between funded and unfunded ERDCs. If companies had known in advance that contributing additional funds to pension schemes to pay for ERDCs (thereby avoiding/reducing a deficit) would be treated differently to unfunded ERDCs then this would have lead to a perverse incentive not to make such contributions. Ofgem's current proposals mean that companies who have chosen not to fund ERDCs receive a higher pensions allowance than companies who have wholly or partly funded ERDCs. We therefore believe that both funded and unfunded ERDCs should be included in the calculations for pension costs.

***Tax***

*Ex ante approach*

We agree that the ex ante approach to tax which was adopted for DPCR4 should be applied to the Transmission Price Control. However, we would expect significant changes in tax law or applicable tax rates or allowances to be taken into account, if and when they occur.

We do not agree that it is necessary to put companies on a common starting gearing position. Each company should start from its actual gearing position. Moreover, we note that the gearing assumptions used for the previous price controls were different for the Scottish transmission companies, Transco and NGC. Therefore, there is no basis on which to determine a common starting gearing position, as it would be

inconsistent with the assumptions on which some of the previous price controls were set.

*Ex post adjustments*

We acknowledge Ofgem's proposals to make ex post adjustments to reduce the tax allowance but believe that this should be a symmetrical adjustment by extending it to include situations where there is lower actual gearing/actual interest. The proposed ex post adjustments recognise that it is unlikely that the actual gearing and actual interest expense assumed in the financial model will be achieved. However, Ofgem's proposals should also include ex post adjustments to increase the tax allowances to reflect lower actual gearing/actual interest than assumed in the financial model.

# 9. Sustainable Development and the Environment

***SF6 Emissions***

If incentives are to be introduced for SF6, we recommend a % leakage rate of portfolio over a 5-year incentive period. There is little we can do to influence actual losses in use but we can focus on prioritising recovery at the end of the asset lifecycle (premature or natural).

We have recently received an Ofgem strawman on SF6 incentives. The incentive does not seem to reference operation within the draft ENA Engineering Recommendation relating to the "Reporting of SF6 Banks, Emissions and Recoveries" from April 2006, nor recognise the increasing industry reliance on SF6 equipment and the different international design standards for SF6 leakage between different plant types.

At transmission voltages, there are no economic alternatives to SF6 for arc interruption, consequently new and replacement switchgear will rely on SF6 technology and contrary to the assumption in Ofgem's strawman, the SF6 inventory will inevitably increase over time. Consequently an incentive based on an absolute leakage target is not appropriate and a % leakage rate of portfolio is the only viable mechanism.

It is important for Ofgem to recognise that the majority of equipment is manufactured for the international market and as a result is subject to international design standards. There is limited scope for UK Transmission licensees to influence the design leakage rate of equipment. In addition, due to engineering design limitations, SF6 design leakage rates can vary between different asset classes e.g. switchgear (IEC 622271-203 for Gas Insulated Switchgear above 52kV) vs transformers. The incentive must therefore recognise design leakage rates relevant to specific asset classes and should operate on portfolios of similar plant types to take cognisance of this difference rather than a single portfolio.

We acknowledge that there may be opportunities to reduce SF6 losses over the lifetime of the asset, through for example, improved handling techniques during commissioning, maintenance and decommissioning. It is important however to ensure that the incentive does not lead to undesirable behaviour and increased risk, through for example, encouraging licensees to reduce maintenance inspections.

Ofgem's strawman suggests a comparison with historic leakage rates and fails to recognise the significant impact of plant coming to the end of its operational life. During the de-commissioning process, plant needs to be degassed and state of the art recovery rates are currently only circa 98%. Given the age profile of the SF6 plant currently in service this does not represent an immediate problem, however as the rate of plant de-commissioning increases over time there will be a corresponding increase in the volume of SF6 gas lost as a result of this activity.

It is important that the levels of incentive substantially exceed the costs of reporting and provide a real incentive to ensure accurate data collection, reporting and most importantly, improvements in gas management practice.

***Visual Amenity***

As the scale of transmission projects is generally much larger and higher cost than distribution, we accept that decisions affecting visual amenity (i.e. projects requiring undergrounding) are best assessed on a case-by-case basis.

The deep reinforcement projects set out in our business plan submission do not include undergrounding costs. In the event that it is necessary to change the scope of any of these projects to include undergrounding then, due to the very high additional costs involved, we would require a resubmission of costs to revise allowances.

For local infrastructure works associated with new connections, in order to accelerate consents timescales, the developer can opt to underground part or all of the connection to the main interconnected transmission system and fund the incremental cost. We see no requirement to change these arrangements.

24 October 2006