

Gas Distribution Price Reviews Initial Proposals May 2007 Response by ScottishPower EnergyNetworks

1. ScottishPower EnergyNetworks ('SPEN') welcomes this opportunity to respond to the points raised in the Initial Proposals Paper.
2. Our responses to the questions raised in Appendix 1 are as follows.

Chapter 2 – form and structure of price control

3. We agree with the proposal to remove the volume driver (2.3). Such a driver is no longer appropriate in view of environmental and energy policy considerations. Companies should not be rewarded (or penalised) for changes in the volume of energy transported.

Chapter 2 question 1 – deadband in revenue recovery mechanism

4. We agree with Ofgem's proposal that the deadband before a penal rate for over-recoveries applies should be at least as wide as at DPCR4.

Chapter 3 – operating expenditure

Question 1 – approach to setting opex allowances

5. The application of a common uplift to costs derived from disaggregated 'bottom-up' benchmarks does not appear to take adequate account of interactions between activities and does not, in our view, remove the need for a glidepath. We also note that significant reductions in opex have been assumed despite the apparent recognition of cost increases in certain categories such as contract labour and materials. Ofgem's analysis does not appear to demonstrate the case for the figure of 2.5% per annum that is applied for underlying opex efficiency. We are therefore concerned that this is a somewhat arbitrary assumption.

Chapter 4 – approach to setting capex and repex allowances – no comment

Chapter 5 – outputs

Question 1 – proposals for changes to outputs and quality of service arrangements

6. We are broadly supportive of converting Overall Standards into Guaranteed Standards or licence requirements, so long as the parameters are appropriate and well defined, and reasonable exclusions are taken into account.
7. It is not clear to us that continued retention of both guaranteed standards and overall performance levels for gas connections is justified (paragraph 5.60).
8. We think that the proposals in 5.98 for "efficient" costs of adoption of private networks to be logged up and included "as appropriate" in the RAV should be reviewed in order that criteria for cost recovery are transparent and fair.

Chapter 6 – incentives

Question 1 – proposals for capex rolling incentive and IQI

9. We think that the incentive properties of a sliding scale mechanism for capex are weakened if there is not a robust benchmark established prior to forecast submissions taking place. In addition, even when it accurately reflects their intentions, the mechanism penalises companies whose capex submission is higher than the level considered appropriate by Ofgem or its consultants. Nevertheless, we agree with the principle that given a level of intended spend, a company should be better off submitting a forecast which is consistent with that intention.

Skills (paragraph 6.27)

10. We think that more consideration should be given to a funding mechanism to address the longer term implications of an ageing workforce. A rolling opex mechanism is unlikely to be effective if companies are uncertain as to whether the upfront costs in addressing this issue will be recoverable in price control. The need to retain existing staff in a national and even international market for skilled labour also needs to be taken into account.

Chapter 7 – sustainable development

Question 2- discretionary reward scheme

11. We are strongly of the view that there is only limited scope for a discretionary reward scheme without compromising the principle that incentives should be transparent, symmetrical and well defined. Issues such as CO poisoning awareness should in our view be addressed through a costed programme rather than a competition for funds.

Chapter 8 – other issues – no comment

Chapter 9 – financial issues

Question 1 – views on factors relevant to cost of capital

12. Given the short time (7 months) since the TPCR proposals, we see no case for a modelling assumption for the cost of debt 20 basis points lower than used at that time. This is not conducive to regulatory certainty or to a stable framework for attracting capital. Real interest rates have risen since the TPCR proposals were published and are continuing to do so. As regards the reference to the CAA's proposed cost of debt of 3% in the case of airport charges, we consider that that estimate is flawed by a number of weaknesses in the CAA's approach, such as the failure to correct for distorting effects on UK gilt yields of pension fund regulations.