

Alan Bryce  
Director Energy Networks  
Scottish Power  
New Alderston House  
Dove Wynd  
Strathclyde Business Park  
Bellshill  
Scotland ML4 3FF

Your Ref: AB/SM  
Our Ref: Networks/Electricity Distribution  
Direct Dial: 020 7901 7240  
Email: david.gray@ofgem.gov.uk

Date: 18 December 2007

Dear Alan,

**Distribution Losses Incentive Scheme - SP Distribution Ltd (SPD) and SP Manweb plc (SPM)**

1. Thank you for your letter of 6 December 2007 concerning the DPCR4 allowed loss percentages (ALP) for SPD and SPM. In it you also referred to your earlier letter of 12 October 2007 on the same subject and to our meeting on 13 November 2007.
2. We have carefully considered the points you have made, including the powers that you have invited us to exercise in SPs favour, and I am writing to advise that we do not believe there is a case for increasing the ALPs of SPD and SPM because of data which has become available since the closure in January 2006 of our investigation into SPM's compliance with obligations in its distribution licence relating to the calculation and reporting of units distributed and losses. As you know, we investigated SP in 2005 due to concerns over data during which we found that SP held very substantial volumes of sales (now known to amount to 1,905 GWh which is worth in the region of £60m) on its balance sheet. SP were aware of these values, to the extent known at the time, but had not reported them to Ofgem, and would have gained significant financial benefit in the context of the Distribution Losses Incentive Scheme but for the compromise outcome of the investigation which was agreed to by SP and Ofgem (see further below).
3. The Gas and Electricity Markets Authority made its decision not to take enforcement action against SP as a result of the investigation only because its concerns were satisfactorily addressed by the specific licence modifications (reducing the ALPs for SPD and SPM to their present levels) and other actions which Scottish Power plc (SP) agreed to at the time.
4. The revised ALPs, to which SP agreed, were calculated by taking the original ALP values (calculated on the ten year average basis from 1994/95 to 2003/04, used for all DNOs in DPCR4) and reducing them by a number of percentage points. The amount of the reduction was the same as the difference (in percentage points) between the reported losses before and after restatement for the three years from 2001/02 to 2003/04. We considered that to be the correct decision in all the circumstances at the time of the investigation and we remain of that opinion because those were the three years affected by the changed approach which SPD and SPM had adopted and which gave rise to the investigation. The agreed ALPs therefore reflected both the original ten year calculation and a specific adjustment relating to the factors considered in the investigation.

5. It is acknowledged that SP made representations at the time of the investigation that the ALPs should be re-set on a more straightforward recalculation of a ten year average of losses using restated data but, after consideration, the Authority did not adopt this approach and made the decision outlined above which SP accepted. Contrary to your assertion, Ofgem did not impose the 3-year methodology on SP<sup>1</sup>, though we expect that the investigation into the circumstances of SP's losses reporting would have continued in the absence of this agreed outcome emerging as a compromise.

6. We note your acceptance of the view that a shift in the level of performance "would not [of itself] have been a cause for revisiting the target"<sup>2</sup>. We fully agree with this (see also paragraph 10 below). As you know, our proposal to change the target only arose as a consequence of our investigation, which found that SP's DCPR4 ALP had been set on the basis of inappropriate information provided to Ofgem by SP. If the ALPs had not been re-set the mechanism would have allowed SPD and SPM to collect excessive amounts from consumers via DUoS billing. Once the ALPs had been re-set it was always possible for there to be a range of financial outcomes, including reductions in allowed revenue, because the losses incentive mechanism is symmetrical in nature (i.e. it provides for both rewards and penalties) and designed to reflect performance in managing network losses over the long term.

7. We also note your argument that it is reasonable for SP to be able to expect to "meet if not in fact outperform the losses incentive target set by Ofgem at any point in time". This suggests that SP considers the incentive to be asymmetric and reward only – whereas we consider that it was well understood by all parties, including SP, that the incentive is symmetrical. As such, we consider your analysis in Appendix 3 is potentially misleading. On a size adjusted basis (e.g. p/customer), Scottish Power received significantly higher rewards in DPCR3 than any other DNO group. Under the current targets your analysis suggests that, although you will suffer a penalty under the scheme in the 2005-10 period, the net outcome over the period 2000-10 will still be positive. As already noted, the projection that you will incur penalties in 2005-10 does not contradict the goal of the scheme. Rather it provides SP with a strong incentive to reduce losses from its system.

8. We note your assertion that recent out-turn data indicates that the re-stated losses for the three year period from 2001/02 to 2003/04 might have been atypically low, owing to volatility in settlement data flows, and that consequently their use in calculating the revised ALPs might have generated unduly low values. You also assert that your losses data has returned to a long term trend and quantify the 10 year average to 2003/04 for each licensee. This appears to differ from the 10 year approach you proposed at our meeting on 13 November 2007 which referred to a ten year average to 2005/06. Notwithstanding that we are not clear which of these approaches you are proposing, we consider that you have not provided sufficient justification for engaging either approach, particularly given that it is common ground that a shift in the level of performance of itself would not be a cause for revisiting targets.

9. As you have pointed out, there are two ways in which the ALP for an electricity distribution licensee can be changed during the DPCR4 period, being a licence modification under Section 11 of the Electricity Act 1989 or use of the mechanism at paragraph 7 of special condition C1 of the distribution licence which allows (but does not oblige) the Authority to issue, with the consent of the licensee, a direction changing the ALP from the start of the next regulatory year.

10. The mechanism at paragraph 7 of special condition C1 has been applied in two recent cases where Ofgem became aware that incorrect data had been used in the ten year average calculation referred to in paragraph 4 above. It is pertinent to note that neither of these cases gave rise to an investigation into the circumstances in which the incorrect data had come to be used. Additionally, in both cases the change to the ALP was necessitated

---

<sup>1</sup> Your letter of 12 October 2007.

<sup>2</sup> Your letter of 12 October 2007.

by a revision to the data on which the original ALP had been set (i.e. corrections were made to data that was incorrect), and not because of out-turn results or projected trend data indicating a shift in the level of performance. We do not consider that a shift in the level of performance of itself amounts to a material change in the quality of the information for the purposes of engaging paragraph 7 of condition C1, and we consider the cases where we have exercised our power under the condition to be distinct from the case for a change in ALPs which you have represented.

11. For the reasons outlined above, we consider that the approach taken in the lead-up to concluding the investigation was correct and that, in all the circumstances, including our careful consideration of the matters raised in your correspondence and our discussions on 13 November, and of the discretionary powers you have asked us to exercise, we are presently not minded to consider re-setting SPD and SPM's ALPs using either of the mechanisms you have suggested to us. However, before reaching a final view we would be prepared to consider any further submissions that SP choose to make in the light of this letter.

12. For the reasons outlined above, we consider that the approach taken in the lead-up to and in concluding the 2005/06 investigation was correct and, in all the circumstances, including our careful consideration of the matters raised both in our discussions on 13 November, in your correspondence and the discretionary powers you have asked us to exercise, we are not minded to re-set SPD or SPM's ALP using either of the mechanisms you have suggested to us on the basis of the submissions you have made to date.

13. On the separate issue of "Pre-BETTA EHV units" referred to in Scott Mathieson's letter of 4 December 2007 addressed to Martin Crouch, we are prepared to consider recommending that the ALP for SPD be adjusted upwards by an appropriate number of basis points to reflect the inclusion of transmission connected load customers in the original ten year average calculation. Our own estimates of this effect are in line with the adjustments quoted in the tables attached to your letter, but I understand that we have requested historic data for the whole period from 1994/95 onwards to assist us in reaching a decision. We consider this to be an example of a data correction issue of the type referred to in paragraph 10 above so that a direction under paragraph 7 of special condition C1 may well be appropriate.

I hope that this makes clear our position, but if you have any particular queries or if there are any additional matters you would like us to consider please do not hesitate to raise them. As I will be leaving Ofgem at the end of this year and Martin Crouch will at the same time be moving to a new role within Ofgem I would suggest you contact Steve Smith or Rachel Fletcher who will be taking over our roles with effect from 1<sup>st</sup> January 2008.

Yours sincerely



David Gray  
Managing Director - Networks