ScottishPower
EnergyNetworks

Your ref.

David Gray
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Our Ref
AB/SM

Date
12 October 2007

[redacted]

Dear David

Following our meeting on 5 October at Millbank and our request to you to amend the ALPs in our Distribution Losses Incentive by direction under Special Condition C1 (or alternatively via a licence condition modification under section 11 of the Electricity Act 1989), I think it is useful to enlarge on, or clarify, some of the points in our case.

BACKGROUND

In 2005, Ofgem investigated SP Manweb and SP Distribution ('SP') because of a concern regarding a significant shift in reported units and losses and the basis on which both were calculated. Ofgem's main issue related to whether or not the significant shift in units could be accounted for by a change in the calculation methodology.

At that time SP representatives explained that the methodology for estimating losses had not changed, but that in initial reporting of sales there had been a shift away from using published line loss factors to the greater use of trends in settlement data. The fact that we were making greater use of settlements data had been previously outlined to Ofgem in early 2004. It would be reasonable to expect that the industry on the whole would make greater use of settlements data and we are given to believe that this is the case today.

We also explained that the timescale of up to 28 months, for the settlements data to run its course, created the need for adjustments to take place in subsequent years. At that time SP was holding 1,905 GWh (relating to a 3 year period for both SPD and SPM) on the balance sheet because we were adopting a prudent policy of not releasing any adjustments until the settlement process was complete to avoid an overstatement in reported revenue. As was evident at the time, and placed beyond doubt by the evidence we presented to you when we met, the period in question was one of significant volatility in settlements data.

You will also be aware that SP gained no financial benefit from holding units on the balance sheet during DPC3 since the losses target in DPC3 was based on a rolling average and "DPC3 units" have a fixed value.

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SP does not challenge that it was right and proper to subsequently incorporate any adjustments to volumes into the DPC4 target. The proposal we mentioned to you when we met incorporates the restated units for these years and brings the 10 year average up to date (end 2005/06) in terms of the latest settlements data which has gone through full reconciliation

However, a particular approach was taken at the conclusion of the investigation, which used 3-years of data, to seek a permanent offset to the 10-year average (rather than simply to modify the 10-year average for the 1,905 GWh). The offset approach was based on Ofgem's hypothesis that the increased use of settlements data in itself caused a sustained reduction in reported losses. We considered that this was flawed at the time and we believe we can now prove this to be the case.

With the fresh data now available to us, comprised of three years more losses data for our own licensees, and data from the other 12 licensees, we consider it necessary to make a correction by amending the ALPs in our licence areas.

MODIFIED 10 YEAR AVERAGE
Had Ofgem not assumed at the time that greater use of settlements data had led to a downward shift in reported losses, it is reasonable to conclude that the shift of itself would not have been a cause for revisiting the target. With the recently available data from the other 12 licensees, some of which show similar levels of volatility to our own, we can indeed see that this was your approach for the rest of the Industry. In this circumstance our targets would have been the 10-year average to 2003/04 as set out in Appendix 1, yielding an expected incentive of £29 million pounds across DPC4. Note that this takes account of the restatement of the 1,905 GWh referred to above which we do recognise as being right and proper.

Ofgem did not adopt this approach, and we estimate that the targets that have been set under Ofgem's revised approach will amount to a penalty of £65 million pounds cumulatively across DPC4, reducing our allowed rate of return by return by 56 basis points. This does not seem to meet the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted; nor does it comply with the objective of the losses incentive mechanism, which is presumably to promote the adoption of sustainable practices.

3-YEAR OFFSET
At the time Ofgem's prime concern, expressed in the Section 28 notice, related to the fact that we had changed the methodology used to calculate the observed losses from 2001/02 in SP Manweb and 2002/03 in SP Distribution. SP did not believe that the greater use of settlements constituted a change of methodology. The increased use of settlements data did however coincide with a reduction in the level of reported losses. One can only conclude from Ofgem's approach that your view at the time was that the increased use of settlements data had actually caused a reduction in reported losses and that this data-induced offset in reported losses would be sustained throughout DPC4. Consistent with this hypothesis, Ofgem's approach was to seek an offset to the 10-year average, rather than to adopt the modified 10 year average based on revising the numbers for the balance sheet volumes. Neither SP nor Ofgem were able to prove or disprove whether increased use of settlements data had

introduced an offset. SP consented to the approach in the knowledge that under Special Condition C1, the target could be modified if new data showed that it did not reflect the underlying performance of the licensees.

We now have 3 additional years of data for our own licensees and data on the trends and volatility for the other licensees. It is now apparent to us that other companies exhibit significant volatility in their reported losses and a similar long-term trend to SP. They were not however subject to any treatment to seek an offset, although they will have had similar data issues, such as making greater use of actual settlements data in the later years implicit in their target compared to the earlier ones.

From the data now available, the reported losses at both SPs' licensed areas have reverted to the long term average, contrary to the hypothesis that settlements data is the cause of a sustained reduction in reported losses and therefore contrary to the 3-year offset approach taken at the time.

The difference between the modified 10-year average and the 3-year offset approach is shown in Appendix 2.

EXPECTATIONS FROM LOSSES INCENTIVE

At our meeting we discussed what you would expect us to earn from the losses incentive over long-term period. We believe that it is reasonable to expect that we can meet if not in fact outperform the losses incentive target set by Ofgem at any point in time, particularly given the fact that the Final Proposals document for DPC4 repeatedly refers to the "benefits" and "retention of the benefits" associated with the scheme.

Basing expectation on actual observations and projecting these to 2010, we set out in Appendix 3 what each company can be expected to earn from the mechanism in DPC3 and DPC4. What can be seen is that, while we recognise that SP performed well in terms of the incentive scheme during DPC3, clearly we were not alone. In stark contrast across DPC4, SP is singly and materially in the penalty zone. Clearly, this position contradicts the goal of the scheme, which is to promote sustainable practice and in the case of SP creates a unique disincentive to invest in loss reduction that is out of kilter with government energy policy.

We do not believe that this was Ofgem's objective in resetting the targets but rather that this has arisen because of the particular approach adopted.

CHANGES IN REPORTED LOSSES TREND

As explained at the meeting my team has taken all reasonable steps to ensure that the change in reported losses cannot be accounted for through equipment configuration or data processing issues under our control. We have conducted a comprehensive internal review and audit, the details of which we shared with your team. covering the following areas:

- Grid supply points in/out metering
- Embedded/micro generation metering
- Interconnection metering
- Half hourly metering data flows

- Super-customer metering data flows
- Unmetered connection volumes
- Data aggregation
- Treatment of MPAN registrations and de-energised premises
- Illegal abstraction.

Our review has confirmed that there is no item within our control that can explain the change in losses. It leads us to conclude that the 3-year period, where observations are relatively low, is subject to significant volatility. Furthermore, it is now apparent to us from our analysis that other companies exhibit significant volatility in their reported losses and a similar long-term trend to SP.

One point that we briefly touched on at the end of our meeting, and that was not covered in the presentation, was the fact that for SP Distribution reported volumes prior to 1 April 2005 (pre BETTA) included EHV customers supplied from 132kV network. These volumes have relatively low loss levels associated with them and this has affect of reducing the target for SP Distribution. From 1 April 2005 (post BETTA) SPD's reported losses exclude these units and therefore reported losses are skewed upwards.

I have also taken this opportunity to attach a copy of the presentation we went through on Friday. We consider this to present strong statistical evidence that, the use of the 3-year period to adjust the SP targets, does not relate properly to the underlying loss parameter. We firmly believe that Ofgem has a duty to act on this evidence to ensure that our target does reflect the underlying performance of the business. For the reasons we have explained, despite attempts on both our sides, the amendments in 2005 have been shown through time to have failed to set an appropriate target.

As I outlined at the close of our meeting I am very keen that we make progress on this issue and should my team or I be able to provide further information or clarity on any aspect of this issue then please do not hesitate to contact us. I look forward to hearing your initial thoughts when we meet on 13th November.

Yours sincerely

Alan Bryce
Director, Energy Networks

APPENDIX 1 – 10 YEAR AVERAGE TO 2003/04

SP Distribution Limited

Losses Restated for 846 GWh held on balance sheet

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	10 year Average
Revised Units distributed including EHV	20822	21251	21686	21712	22368	22381	22694	22561	22719	22718	220911
Revised Losses including EHV	1380	1307	1409	1398	1451	1456	1461	1466	1064	967	13359
Revised Losses (%)	**6.63%**	**6.15%**	**6.50%**	**6.44%**	**6.49%**	**6.51%**	**6.44%**	**6.50%**	**4.68%**	**4.26%**	**6.05%**
									Losses Target		**6.05%**

SP Manweb Plc

Losses Restated for 1059 GWh held on balance sheet

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	10 year Average
Revised Units distributed including EHV	18487	18521	18418	18565	17309	17184	17289	17250	17213	17181	177417
Revised Losses including EHV	1126	1233	1228	1259	1275	1289	1349	1023	895	781	11458
Revised Losses (%)	**6.09%**	**6.66%**	**6.67%**	**6.78%**	**7.36%**	**7.50%**	**7.81%**	**5.93%**	**5.20%**	**4.54%**	**6.46%**
									Losses Target		**6.46%**

APPENDIX 2 – 10 YEAR AVERAGE VERSUS 3 YEAR OFFSET

SP Distribution Limited	Revised 10 year Average	3 year target	Difference
Losses target	6.05%	5.13%	0.92%
Estimated revenue adjustment for years 05/06 to 09/10	£2m	£(45m)	£(47)m

SP Manweb Plc	Revised 10 year Average	3 year target	Difference
Losses target	6.46%	5.32%	1.14%
Estimated revenue adjustment for years 05/06 to 09/10	£27m	£(20m)	£(47)m

APPENDIX 3 – LOSSES INCENTIVE: INDUSTRY COMPARISON