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Your ref.

Our Ref

Date
28 July 2008

Contact / Extension



Dear Rachel

**DISTRIBUTION LOSSES INCENTIVE SCHEME
SP DISTRIBUTION LIMITED ("SPD")
SP MANWEB PLC ("SPM")**

I refer to your meeting with Scott Mathieson and Suzanne Wilson on 8 July 2008 in which you requested that SPD/SPM provide a written response to David Gray's letter of 18 December 2007 laying out our legal arguments that demonstrate to Ofgem that there is a justifiable basis for the Allowed Losses Percentages ("ALPs") to be reconsidered.

Introduction

Firstly may I confirm that the reason that no formal response to the legal position has been provided to date is that we considered it critical, in light of specific comments made by David Gray in paragraph 11 of his letter, that the discrepancies over the data provided by Elexon be resolved as a matter of priority.

As such we have focussed our efforts over the last six months on working with the Ofgem team to ensure that the data has been reconciled to your satisfaction. I would refer you to the correspondence which has ensued over the year to date including your letter dated 29 February 2008 and Scott Mathieson's letter to you dated 28 March 2008. I understand from Paul Darby's comments at the meeting on 8 July that Ofgem are satisfied that the data is now the best available. I am pleased that our respective teams have worked well together in this regard.

Secondly we believe that the proposal regarding the correction of the EHV units was not submitted to the GEMA board meeting on 18 July 2008 pending the outcome of these current discussions relating to the issue of the ALPs in general. I do however understand that it is agreed between us that the correction of the target for DPCR4 relating to EHV units will be proposed to the GEMA board in due course for ratification.

At this juncture it is imperative that we make our position quite clear on the decision to accept the alterations made to the ALPs in 2006 in light of a comment made by Paul Darby at the meeting on 8 July. The correspondence between Ofgem and SPD/SPM bears out our position that we reluctantly accepted the adjustment to the ALPs as an alternative to the prospect of a continued dispute with Ofgem bearing in mind:-

- (i) the considerable time and resources which we were aware required to be dedicated to such a matter; and
- (ii) the misleading impression given by the poor quality of the data at the time.

We do not accept the position as proffered by Paul Darby that we agreed, as part of any negotiated deal, that we were fixing the targets for DPCR4 immutably or that there was any linkage to DPCR3.

SPD/SPM have always understood that the ALPs could be revised at any time during DPCR4 under Special Condition C1 in light of issues regarding quality of data, as supported by the email from Scott Mathieson to Martin Crouch dated 30 November 2005.

Legal Basis for Ofgem to exercise its powers under Paragraph 7 of Special Condition C1

In terms of providing justification which enables Ofgem to alter the revised ALPs relating to SPD/SPM, the basis of our legal position was outlined at the meeting on 8 July and reiterates and develops upon the position which has been proffered in our correspondence and presentations to date, most recently my letter to David Gray dated 6 December 2007.

The position is as follows:-

1. Paragraph 7 of Special Condition C1 permits Ofgem to direct a change to the value of the ALPs in the event that they are satisfied that there has been a "material change", which can be an improvement or a deterioration, in the "quality of the information used to derive the adjusted system entry volumes or adjusted units distributed";
2. In considering whether or not to make such a direction, Ofgem requires to have regard to the purpose of the scheme which provides that it is "to establish the amount of incentive that adjusts allowed demand revenue so as to reflect the performance of the licensee...in respect of distribution losses";
3. It is acknowledged that the intention of the incentive scheme is to create a "symmetrical" incentive in that the performance of licence holders may result in rewards if the targets are exceeded or penalties if the licensee fails to meet the targets. Under normal circumstances with a target set on a fair and equitable basis, one could expect to have a 50:50 probability of achieving the target. However SPD/SPM are able to demonstrate that with the ALPs as currently set, the probability of achieving the target is so substantially diminished that it distorts the incentive scheme so as to create an asymmetrical position which results only in penalty for SPD/SPM;
4. It is noted that Ofgem has utilised its powers under paragraph 7 of Special Condition C1 on two previous occasions, both of which were at the licensee's instigation, where data

used to calculate the ALPs was shown to have contained errors which required to be corrected. Both resulted in minor revisions to each licensee's targets;

5. It is important to note that SPD and SPM are the only DNOs to have been subjected to any alteration to ALPs at the instigation of Ofgem during DPCR4. It was acknowledged by Ofgem in an email from Martin Crouch dated 14 December 2005, a copy of which is enclosed, that paragraph 7 of Special Condition C1 could have been utilised at the time in order to effect the changes to the ALPs but Ofgem elected, for practical reasons, to proceed by the alternative route of modification under section 11 of the Electricity Act 1989;
6. In any event on the basis that Ofgem recognises and accepts that it was entitled to utilise the mechanism under paragraph 7 of Special Condition C1 to effect the original changes to SPD/SPM's ALPs, it must necessarily follow that Ofgem also accepts that the breadth of the power provided to Ofgem under paragraph 7 is more expansive than being restricted exclusively to the correction of errors. It appears that Ofgem's interpretation of its power has subsequently been unnecessarily narrow;
7. In order to justify the use of paragraph 7, Ofgem requires to be satisfied that there has been a "material" or significant change in the quality of the data/information used. SPD/SPM consider that the reconciliation exercise which has taken place supports the position that there has indeed been such a significant change in the quality of the information. In addition SPD/SPM are able to point to independent, objective and supporting evidence by way of the Elexon report and the BSC's auditor's qualification. Specifically, the supporting evidence demonstrates the following:-
 - (i) SPM has fully reconciled the reported losses in 2003/4 and 2005/6 and verified that we are using settlements data in reporting units distributed in those years;
 - (ii) Ofgem has agreed, following a comprehensive review and audit in which the Ofgem team participated, that the variations in losses cannot be accounted for through equipment configuration or data processing issues under SPD/SPM's control;
 - (iii) A review of the BSC Audit reports produced by PwC for the period 2003 to 2007 has been undertaken by SPD/SPM. For the period prior to 2005/06, for which there was particularly high volatility, the auditor's reports are qualified due to the significant levels of error within Settlements. From 2005/06 onwards the reports are no longer qualified and in particular the March 2007 report (relevant extract enclosed) notes a marked improvement in previously identified issues as a result of the focus by participants;
 - (iv) The Elexon Report of the Volume Allocation Standing Modification Group ("VASMGM"), known as the Standing Issue 34 Report, relating to an issue raised by SPD/SPM, was discussed at the BSC Panel meeting on 12 June 2008, (copy enclosed). In the conclusion to the report the VASMGM notes that the level of distribution losses in SPD/SPM GSP group is unusual over the period examined when compared to the rest of the market. Further, the VASMGM report also

concludes that "distribution losses are volatile across the market, on a month by month basis and that this volatility is highly likely to be caused by inaccuracies and features of current profiling arrangements." In the period upon which Ofgem relied to make the adjustments, it is acknowledged within the industry that performance meter reads were not as good as the current benchmark of 97%; and

- (v) Appendix 3 of the same report provides an overview of the quality of demand data and in particular a measure of the level of error annually between 2003 and 2008. This calculates the percentage error in the Annual Demand Ratio (the measure of variation between the total annual profiled Non Half Hourly (NHH) consumption and the total annual "metered" NHH consumption (Metered NHH consumption is effectively the sum over a year of profiled NHH demand per Settlement Period after the application of Line Loss Factors and GSP Group Correction Factor). This analysis shows that in SPM in 2003/04 there was a relatively high data error of 6.3% compared to an industry market error of 2.1% on consumption data. This compares to 2007/08 where SPM are at 0.3% compared to a market error of 0.7%. This shows that SPM had a high error in relation to the industry at the time and was unique compared to the industry in that period which was also not known at the time of setting the revised targets. That is also not the case currently, where in 2007/08 the data seems to be more robust and closer to the longer term average (10 year).¹
8. At the meeting on 8 July, I understand that you indicated that you were looking for new information to be submitted and that merely being in possession of "better" information now in 2008 compared to that available to the industry as a whole in 2005 is insufficient to enable Ofgem to trigger this mechanism to change the ALPs. SPD/SPM fundamentally disagree with this position. It is patently clear that the analysis of the data which has taken place demonstrates that "better" can indeed be interpreted as being of improved quality for the reasons provided in paragraph 7 above which provide Ofgem with sufficient justification to direct a change to the ALPs. By way of example, at the time of setting the revised ALPs, Ofgem acknowledged in its letter dated 14 September 2005, that it was appropriate to use more current information which it deemed to be better information in order to establish the benchmark for 06/07 onwards;
9. It is important to note the restated losses targets were based on a three year average approach which compared reported units against restated units in the period 2001/2 to 2003/4 using 2004 and 2005 Settlements Data for the relevant years. The difference between the two was used to adjust the target. This produced a result which is close to the arithmetical average of the three years in question and vastly different to a 10 year average incorporating fully restated units to 2003/4. As a consequence by focussing on these three years, it has produced a vastly different target and in the process has amplified the impact of acknowledged poor data quality; and
10. The effect of the adjustment is that SPD and SPM both face a negatively biased target. Across a 10 year period used by Ofgem to set the targets for all other DNOs, including fully restated data for the years on which Ofgem focussed, the Settlements Data incorporates significant volatility caused by over and under reporting of import energy,

¹ The corresponding data for SPD is not available to us.

export energy or accounting of GSP metering with the result causing losses on the Distribution system to vary.

In conclusion, there is sufficient evidence, supported by independent third parties, that the quality of the data used to calculate the adjusted ALPs has improved to such a material extent, that Ofgem are entitled to review and revise the ALPs for SPD/SPM accordingly.

Ofgem's obligations under the Internal Markets Electricity Directive 2003/54 ("IMED")

In conjunction with the legal basis presented so far, Ofgem will be mindful of the UK's obligation to ensure, under Article 3 of IMED, that the State shall not discriminate between these [electricity] undertakings as regards either rights or obligations".

It is of considerable concern to SPD/SPM that during DPCR4:-

1. SPD/SPM are the only DNOs whose ALPs have been altered at the instigation of Ofgem;
2. SPD/SPM are the only DNOs whose targets have been set to such a level that there is a less than 50:50 probability that the targets may be attained and indeed that it is much more likely that SP will fail to do so;
3. The ALPs for SPD/SPM are based on a three year average versus a ten year average for all other DNOs as explained in more detail above at paragraphs 11 and 12;
4. SPD/SPM are the only DNOs which have suffered any penalties whatsoever in contrast to all other DNOs which have achieved substantial gains during DPCR4.

It is apparent that SPD/SPM have been treated differently to all other DNOs and the impact of this difference in treatment has resulted in SPD/SPM being at a competitive disadvantage, the material impact of which amounts to approximately £70m during DPCR4. Such difference in treatment is not objectively justified and as such it is fundamentally inequitable.

It is not legitimate for Ofgem to refer to the concluded s28 investigation as justification for discriminating against SPD/SPM in relation to the rest of the industry. At no stage during the investigation did Ofgem establish any findings against SPD/SPM. Indeed since then we have successfully reconciled the data which has demonstrated to Ofgem that the cause of the concern was the unreliable and inaccurate data as opposed to any act or omission on the part of SPD/SPM. Despite this, SPD/SPM have in effect suffered a penalty, which if left uncorrected, is of the order of £70m. Neither Ofgem nor SPD/SPM intended for this to happen when the revised targets were set.

Further Considerations

It is further not reasonable for Ofgem to refuse to exercise its powers under paragraph 7 of C1 due to its concerns of precedent setting. Any argument which Ofgem may advance that if it is required to review SPD/SPM's targets, it follows that Ofgem is also obliged to review the ALPs of all DNOs simply does not stand up. SPD/SPM were dealt with in a unique way and any precedent relating to this matter was therefore set in 2005/6 when Ofgem revised the ALPs originally. No such similar concern was expressed by Ofgem at that time when steps were taken to revise SPD/SPM's targets.

It is worth reminding Ofgem that its powers to re-adjust targets are not limited solely to occasions where the revised target results in a negative financial impact on the DNO but also apply where an adjustment would have a positive financial effect. The intention of paragraph 7 is clearly to afford flexibility by allowing its right to trigger whether there has been an improvement or a deterioration in the quality of the information used.

Finally it is entirely inappropriate and inequitable to resist reconsideration of the ALPs for DPCR4 on the basis that SPD/SPM made substantial gains during DPCR3 and that if the targets during DPCR4 are reconsidered, Ofgem would be forced to review the targets during DPCR3 too. SPD/SPM conformed in all respects with the terms of the incentive scheme for DPCR3 together with all other DNOs and should not be prejudiced for doing so. We are not aware, for example, that Ofgem has felt compelled to instigate investigations into any other DNOs due to the substantial levels of gains during DPCR3.

Conclusions

On the basis of the justification submitted, Ofgem is entitled, indeed it is its duty as a fair and equitable regulator, to exercise its power to review the ALPs for SPD/SPM by utilising its rights either under paragraph 7 of Special Condition C1 or section 11 of the Electricity Act 1989. I would welcome confirmation from Ofgem that it intends to do so.

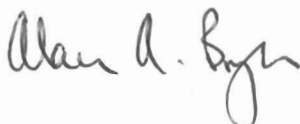
If Ofgem's position is that the supporting evidence is still insufficient and Ofgem is able to give more explicit guidance as to what level of evidence is required, I would encourage our teams to continue to work together for a further limited period of time.

If however Ofgem refuses to exercise either its statutory power under the Electricity Act or its power under paragraph 7 of the licence on the basis of the evidence presented and is unwilling to provide any specific guidance as to this legal hurdle, SPD/SPM will conclude that Ofgem's decision has been made on an irrational and unreasonable basis and further that it is acting contrary to its obligations under IMED.

I must stress that this matter and its materiality are of such concern to our parent company, Iberdrola, that it is inevitable that in such circumstances we would be left with no alternative but to pursue the various options available to us in order to resolve this matter.

I suggest that a further meeting takes place between you, Scott and Suzanne, and that separately I shall arrange to meet with Steve Smith to discuss.

Yours sincerely



Alan Bryce
Director - Energy Networks