SP ENERGY NETWORKS

Regulation and Commercial Director's Office

Your ref

Our Ref

Date

4 November 2008

Contact / Extension

[redacted]

Steve Smith
Managing Director – Networks
Office of Gas and Electricity Markets
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Dear Steve

Allowed Losses Percentages (ALP) in relation to SP Distribution Limited ("SPD") and SP Manweb plc ("SPM")

Thank you for your letter of 27th of October 2008 requesting further information. We request that Ofgem addresses the following adjustments:

(A) Change to SPD Losses target to take account of the manifest error introduced by the re-designation of EHV units from Distribution (pre-BETTA) to Transmission (post-BETTA). We understand from Ofgem that you agree an adjustment is necessary for this change. Given previous treatment of adjustments made by Ofgem to the targets of other DNOs for manifest errors, we see no obvious necessity for Ofgem to consult on this change. However, there are interactions with (B) below and accordingly we have included the requested information.

(B) Further changes (beyond those required for EHV) to SP Distribution's allowed losses percentages (ALPs) and changes to SP Manweb's ALPs to correct an adjustment made by Ofgem in 2005 ("the 2005 Adjustment") after the conclusion of the DPCR4 price control negotiations. This followed an Inquiry into the volatility of SPD and SPM reported losses. We propose that two alternative sets of changes are considered:

    (i) Reversing the 2005 Adjustment, so that the ALP figures for SPD and SPM are calculated on the same basis as for other DNOs. We call this case "Full Correction"; and

    (ii) Effecting a correction only for 2007/08 and later years of DPCR4. This would not fully correct the negative impact on SP Energy Networks ("SPEN") of the 2005 Adjustment, but would have lesser impacts on consumers. We call this case "Limited Correction".

<u>Pre-BETTA EHV</u>

Prior to BETTA go-live, some units recorded as SPD EHV units were related to Transmission-connected load customers. Following BETTA go-live these units ceased to be recorded against SPD. This meant that the pre-BETTA overall losses target for SPD was set too low as a consequence.

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Accordingly, the existing ALP needs to be increased with effect from the date of BETTA go-live, to take this change of procedure into account. We have calculated the necessary increase to be 0.23% in 2005/06 and 0.21% in each of the years 2006/07 to 2009/10[1].

The impact of this change alone would be as follows:

TABLE 1

SPD only	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Current ALPs	5.41%	5.13%	5.13%	5.13%	5.13%	
EHV adjustment	0.23%	0.21%	0.21%	0.21%	0.21%	
Revised ALPs	5.64%	5.34%	5.34%	5.34%	5.34%	
Allowed revenue ALP (penalties)/ incentives (£M)	(2.63)	(4.60)	(10.30)	(6.11)	(6.31)	(29.95)
Current or forecast allowed revenue ALP (penalties)/ incentives prior to adj. (£M)	(5.11)	(6.85)	(12.63)	(8.52)	(8.79)	(41.90)
Change in allowed revenue (£M)	2.48	2.25	2.33	2.41	2.48	11.95
Change in allowed revenue recovered via 3.6% price change in 2009/10 (£M)						11.95

To collect the full value of allowed revenue associated with these changes in 2009/10 will require a price change of less than 3.6% above current forecasts.

We consider the adjustment to be appropriate because it is necessary to reverse a change in the calculation of the losses, which has arisen as a result of a change in the way EHV units are accounted for. We would expect to make the adjustment equally, in percentage terms, across all distribution customers, to reflect the incidence of the original under-charging. A change of 3.6% in Distribution charges would equate to around 0.6% in a connected customer's bill on average (about £3.00 per annum for a typical LV customer).

Full Correction

In December 2005, after the DPCR4 negotiation had been completed, Ofgem proposed to ScottishPower an adjustment to the way the ALP target was calculated for our two networks, in order to correct what they perceived at the time to be an unexplained methodology change. Accordingly, the target was effectively adjusted with reference to 3 years of data rather than the 10-year basis used for other DNOs. ScottishPower, despite significant misgivings, accepted the proposal given that the relevant licence condition (Special Condition C1) allowed for the Authority to amend the ALP as appropriate throughout the period.

Subsequent events have shown that the low losses were in fact an artefact arising from the volatility in settlements data and that there was no methodology change and therefore no justification for the change in the way the ALP was calculated. The full correction option therefore aims to reset ALP based on the approach that Ofgem used for the other DNOs and to apply that change for the period of DPCR4.

[1] For reference to the basis of this calculation please refer to our letter to Martin Crouch dated 04 December 2007, sent by Scott Mathieson

This involves basing the targets on a 10-year average taken to 2003/04 including full restatement of any historic lead or lag units. The targets under this scenario would become 6.32% for SPD and 7.00% for SPM, compared to the current targets of 5.13% and 5.32% for both companies respectively[2].

The allowed revenue impacts of these changes are as follows:

TABLE 2

SPD	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Revised ALPs (incl. EHV adjustment)	6.32%	6.32%	6.32%	6.32%	6.32%	
Allowed revenue ALP (penalties)/ incentives (£M)	4.68	5.87	0.54	5.11	5.25	21.45
Current or forecast allowed revenue ALP (penalties)/ incentives prior to adj. (£M)	(5.11)	(6.85)	(12.63)	(8.52)	(8.79)	(41.90)
Change in allowed revenue (£M)	9.79	12.72	13.17	13.63	14.04	63.35
Change in allowed revenue recovered via 4% price change in 2009/10 (£M)						13.11
Change in allowed revenue carried forward to DPCR5 but ameliorated by depreciation change (increase from 20 to 22.75 years) (£M)						50.24

If this scenario were adopted the licensee would propose to cap any increase in prices for 2009/10 to 4% above current forecasts or £13.11M of SPD allowed revenue, with the balance of £50.24M being carried forward to the DPCR5 period. In order to limit short-term impacts on consumers, it would be possible to offset this sum against DPCR5 revenue requirements by changing depreciation lives from 20 years to approximately 22.75 years.

[2] Reported losses in 2007/08 were 5.88% for SPD and 6.09% for SPM before adjustment for settlement adjustments that relate to prior periods.

TABLE 3

SPM	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Revised ALPs	7.00%	7.00%	7.00%	7.00%	7.00%	
Allowed revenue ALP (penalties)/ incentives (£M)	6.86	13.01	1.81	8.52	8.65	38.85
Current or forecast allowed revenue ALP (penalties)/ incentives prior to adj. (£M)	(2.97)	(1.54)	(13.07)	(6.96)	(7.29)	(31.83)
Change in allowed revenue (£M)	9.83	14.55	14.88	15.48	15.94	70.68
Change in allowed revenue recovered via 4% price change in 2009/10 (£M)						7.91
Change in allowed revenue carried forward to DPCR5 but ameliorated by depreciation change (increase from 20 to 22.25 years) (£M)						62.77

If this scenario were adopted the licensee would propose to cap any increase in prices for 2009/10 to 4% above current forecasts or £7.91M of SPM allowed revenue, with the balance of £62.77M being offset against DPCR5 revenue requirements by changing depreciation lives from 20 years to approximately 22.25 years.

We consider the adjustments set out in Tables 2 and 3 to be appropriate because they are necessary to reverse a discriminatory change, made on a basis which can be shown to be invalid, applied to the losses targets for SPD and SPM after the DPCR4 negotiations had been completed.

We would expect to make the adjustment equally, in percentage terms, across all distribution customers, to reflect the incidence of the original under-charging. A change of 4% in Distribution charges would equate to around 0.7% in a connected customer's bill on average (about £3.40 per annum for a typical LV customer).

Limited Correction

Although SPEN's position is that it is appropriate to make the full correction to reverse the flawed 2005 Adjustment and achieve parity with its industry peer group, we have also explored an alternative option, which has a significantly smaller impact on consumers. This would not fully reverse the effect of the 2005 Adjustment but would mitigate its impact for 2007/08 and subsequent years.

This option would involve revising the targets based on a 3-year average from 2005/06 to 2007/08, but only taking effect from 2007/08. Although this would maintain use of a 3 year reference point, it would be applied to a period when settlements data was of significantly higher quality than the 3 years used in the 2005 Adjustment – which three years are clearly a statistical outlier. The improvement in data quality is attested to by BSC Audit Reports, and in particular the fact that the auditor is now prepared to give an unqualified opinion. Under this option the revised target would be 6.00% for both SPD and SPM. Because the EHV change is in the underlying data for the three years 2005/06 to 2007/08, the EHV correction for SPD is subsumed within the Limited Correction for 2007/08 through to 2009/10.

The allowed revenue impacts of these changes are as follows:

TABLE 4

SPD	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Revised ALPs from Limited Correction	5.41%	5.13%	6.00%	6.00%	6.00%	
EHV adjustment	0.23%	0.21%	n/a	n/a	n/a	
Overall ALPs	5.64 %	5.34 %	6.00%	6.00%	6.00%	
Allowed revenue ALP (penalties)/ incentives (£M)	(2.63)	(4.60)	(3.00)	1.45	1.47	(7.31)
Current or forecast allowed revenue ALP (penalties)/ incentives prior to adj. (£M)	(5.11)	(6.85)	(12.63)	(8.52)	(8.79)	(41.90)
Change in allowed revenue (£M)	2.48	2.25	9.63	9.97	10.26	34.59
Change in allowed revenue recovered via 4% price change in 2009/10 (£M)						13.11
Change in allowed revenue carried forward to DPCR5 but ameliorated by depreciation change (increase from 20 to 21 years) (£M)						21.48

If this scenario were adopted the licensee would propose to cap any increase in prices for 2009/10 to 4% above current forecasts or £13.11M of SPD allowed revenue, with the balance of £21.48M being offset against DPCR5 revenue requirements by changing depreciation lives to 21 years.

TABLE 5

SPM	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Revised ALPs	5.85%	5.32%	6.00%	6.00%	6.00%	
Allowed revenue ALP (penalties)/ incentives (£M)	(2.97)	(1.54)	(7.04)	(0.69)	(0.84)	(13.08)
Current or forecast allowed revenue ALP (penalties)/ incentives prior to adj. (£M)	(2.97)	(1.54)	(13.07)	(6.96)	(7.29)	(31.83)
Change in allowed revenue (£M)	-	-	6.03	6.27	6.45	18.75
Change in allowed revenue recovered via 4% price change in 2009/10 (£M)						7.91
Change in allowed revenue carried forward to DPCR5 but ameliorated by depreciation change (increase from 20 to 20.5 years) (£M)						10.84

If this scenario were adopted the licensee would propose to cap any increase in prices for 2009/10 to 4% above current forecasts or £7.91M of SPM change allowed revenue, with the balance of £10.84M being offset against DPCR5 revenue requirements by changing depreciation lives to 20.5 years.

We consider that the adjustments set out in Tables 4 and 5 are significantly less than the appropriate figure because it would not be sufficient to reverse fully a discriminatory change, made on a basis which can be shown to be invalid, applied to the losses targets for the SP networks after the DPCR4 negotiations had been completed. It would leave SP Energy Networks with a revenue loss of some £20.39M across the DPCR4 period arising from the remaining impact of the 2005 Adjustment. However, it would go some way toward mitigating the effect of the 2005 Adjustment with a significantly reduced impact on consumers, and on that basis we believe it should be considered.

We would expect to make the adjustment equally, in percentage terms, across all distribution customers, to reflect the incidence of the original under-charging. A change of 4% in Distribution charges would equate to around 0.7% in a connected customer's bill on average (about £3.40 per annum for a typical LV customer).

Effect on SPD and SPM of not making adjustments

The current allowed losses targets are leading to an adverse impact on our allowed rate of return of around 60 basis points across the 5 years of DPC4, for reasons wholly unconnected with our actual performance in managing technical and/or non-technical losses.

This effect is further compounded by other factors, including the growth term, quality of supply targets and our operating and investment expenditure requirements. We are delivering for consumers upper quartile performance in customer interruptions, a good performance in investing our capital allowances and by Ofgem's opex league table, performing relatively efficiently in terms of operating expenditure. Despite this, our rate of return is being impaired by around 150-160 basis points.

When we analyse the impact of losses in this context we are left in no doubt that there is significant impact on our business on a stand-alone basis. Using the financial model provided by Ofgem at the conclusion of DPCR4 to reconcile the package for revenue that we accepted and analysing the impacts of losses and these other factors, our business' ability to finance its activities is severely impaired. For example, in the case of SPM the current situation leads to gearing of 72% against RAV, FFO interest coverage of 2.4x and retained cash-flow/net debt of 7.1% by 2009/10, considerably worse than the Ofgem benchmarks for adequate investment grade rating of <65%, >3x, and >9% respectively.

In terms of the investment grade credit ratios analysis, the problem is not as severe in SPD because of continued funding from pre vesting assets, however the absolute impact on returns is just as pronounced and it is clear that in the absence of making these corrections, the revenues for SPD and SPM would be significantly below the levels intended, or necessary to meet target levels of return, as a result of an artefact of the figures rather than anything within management control. For this reason, we believe that it is imperative to make the changes requested.

We are putting forward the Limited Correction option without prejudice to our rights to pursue the Full Correction, or any other appropriate remedy, in the event that an agreed outcome is not achieved.

Hopefully you will now have sufficient information to provide us with your draft impact assessment and proposed consultation by mid November. When we have received your document and had the opportunity to initially review its content we will contact you to confirm when we will be able to submit our comments or proposed revisions. We would intend to submit these promptly.

Yours sincerely

pp Alan Bryce
Director, SP Energy Networks