



# ScottishPower EnergyNetworks

David Gray  
Managing Director, Networks  
Ofgem  
9 Millbank  
London SW1P 3GE

Your ref.

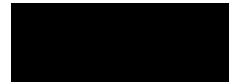
Our Ref

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Date

06 December 2007

Contact / Extension



Dear David

## **DISTRIBUTION LOSSES INCENTIVE SCHEME SP DISTRIBUTION LIMITED AND SP MANWEB PLC (“SP”)**

I refer to my letter dated 12 October 2007 and to our subsequent discussion in relation to this matter on 13 November 2007. In advance of Ofgem issuing a formal response to my letter dated 12 October 2007, I have taken the opportunity here to set out the legal context within which, in our submission, Ofgem should consider our request to effect a further change in SP's revised Allowed Loss Percentage (“ALP”) during DPCR4.

In our discussion, you appeared to be unwilling to re-adjust our revised ALPs, given your view that this would amount to a “re-opening” of the price control package. You also felt that understanding our legal arguments would be helpful, particularly so we are aware of each others' position in advance of the meeting, scheduled for 20 December between Alastair Buchanan and José Luis del Valle. I therefore set out below our thinking on why we believe that Ofgem has a duty to act on our submission and why we believe the mechanisms available to the Authority are appropriate in the circumstances.

### **Unfair impact of revised ALPs during DPCR4**

In terms of the financial impact on SP of the revised ALPs, I understand from our discussions on 13 November 2007 that Ofgem appreciate the position as stated in my letter dated 12 October 2007.

The DPCR4 proposal documents state that the objective of the distribution losses incentive is to encourage DNOs to earn incentive payments in order to invest in low loss equipment, more effective network configuration and projects to encourage energy efficiency. SP's revised ALPs (which are calculated differently from those of all other DNOs) are not consistent with

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the intended outcome of DPCR4, as there is no reasonable likelihood of SP achieving the targets. This sits uneasily with SP as many of the other DNOs have already earned substantial sums in the first two years of this review period.

SP also considers that this difference in treatment creates a competitive disadvantage for SP having regard to the role of benchmark competition.

### **Rationale for Ofgem to act**

SP's position is that the revised ALPs to which SP are subject (which set targets that SP has no reasonable likelihood of achieving and which place us at a competitive disadvantage to other DNOs) can no longer be justified in the context of the objectives of the DPCR4 losses incentive. Indeed, in my view, SP are being penalised as a result, in contrast to other licence holders.

In such circumstances, and in light of Ofgem's previous intervention to revise SP's ALPs for DPCR4 (which took place a full year after SP had notified the Authority of our acceptance of the DPCR4 proposals), it is SP's submission that Ofgem would risk acting inconsistently and inappropriately were it not now to review and amend SP's ALPs in order to redress this imbalance. The intervention made to amend the ALPs can now be seen to have been miscalculated and is having the effect of reducing SP's returns well below the figures intended by the DPCR4 settlement. We do not believe that correcting an adjustment made after acceptance of the DPCR4 proposals, which adjustment can now be seen to have been excessive, amounts to re-opening the intended package of DPCR4 which was based on a broadly neutral assumption for losses.

Amendment of the ALPs is also required, in our submission, in order for Ofgem to avoid maintaining an unjustifiable difference in treatment of SP (as compared to other DNOs), which could amount to discrimination within the meaning of Article 3 of Directive 2003/54.

### **Mechanisms for revising ALPs during DPCR4**

As you will be aware, there are two potential mechanisms available to Ofgem to effect a change to the ALPs during DPCR4, either by way of:-

1. Direction under Paragraph 7 of Special Condition C1 of the Licence; or
2. Modification under Section 11 of the Electricity Act 1989

The mechanism provided for in Paragraph 7 of Special Condition C1 of the licence entitles Ofgem to direct the licensee to alter the ALPs provided Ofgem is satisfied that there has been a material change in the quality of the information used to calculate either purchases or units distributed.

The period used to establish the target was one of considerable volatility and the position was further exacerbated by the imposition by Ofgem of the 3-year methodology. SP believe the

data available today is substantially less volatile and therefore of enhanced quality than that utilised at the time of the ALP adjustment by Ofgem in 2005.

Furthermore, this mechanism was employed for the purposes of altering the ALPs in at least two other instances during DPCR4. In our own case, we note that the letter/email exchange culminating in the email from Ofgem dated 14 December 2005 (attached) contemplated that this mechanism might be used to bring about a further adjustment to the revised SP ALPs during DPCR4.

As an alternative, it remains open to Ofgem to re-employ its broad power under Section 11 of the Electricity Act 1989 in order to modify the ALPs. Ofgem's ability to utilise this power is not tempered to the extent of requiring to satisfy any test but does require a period of public consultation.

I would remind Ofgem, as illustrated by the attached email, that for the purposes of the adjustment of the ALP in 2005, Ofgem proceeded by way of modification although both parties recognised at the time that either of the two mechanisms, as described above, would have been appropriate.

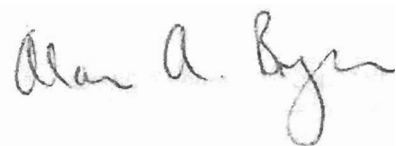
### **Conclusions**

I believe that in our discussions SP has presented a rational and compelling case, outlining the inequity of the current losses targets in our companies. Strong statistical evidence has been submitted to Ofgem in our presentation on 5 October 2007 and subsequent letter dated 12 October 2007.

Given the licence mechanisms available to Ofgem, and the adjustments that have already taken place in SP and other companies, revising the targets again to set a target that we have a reasonable likelihood of actually achieving constitutes a reasonable request. I would again emphasise that we believe Ofgem's original intention was to set fair targets and that the problem we highlight now, is a consequence of the particular statistical approach taken to reset the targets.

I would reiterate that I am extremely keen that we make progress on this issue. If you consider that it would be helpful to convene a further meeting of our respective teams in advance of the meeting on 20 December 2007 to discuss these matters, please contact me.

Yours sincerely,



**Alan Bryce**  
**Director, EnergyNetworks**

**Brady, Jane**

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**From:** Martin Crouch [Martin.Crouch@ofgem.gov.uk]  
**Sent:** 14 December 2005 16:46  
**To:** Mathieson, Scott  
**Cc:** Colette Schrier; Mark Cox  
**Subject:** RE: Losses investigation

Scott,

I understand you spoke to Colette about the process this week and thereafter. We will endeavour to get you a letter and draft closure statement after the Authority meeting tomorrow.

On the licence modification, apologies for not reverting sooner. While we understand that the value of ALP for 2006/07 onwards can be effected via paragraph 7 of C1 as you say, we consider that (as a modification of C1 is needed anyway) it would be more transparent and hence preferable to effect the changes to both the 2005/06 and the 2006/07 onwards values of ALP through the licence mod. This would involve changing ALP to ALPt and putting both values for both licensees into Annex 1 of C1. I believe this is only a presentational issue, but happy to discuss if you disagree. We don't envisage other licence mods being needed.

On the description of your process for the initial loss estimate, we have now reviewed this here and it might be useful for Colette to talk this through with someone at your end - perhaps you could let us know who would be most appropriate?

Thanks  
Martin

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**From:** Mathieson, Scott [mailto:Scott.Mathieson@scottishpower.plc.uk]  
**Sent:** 30 November 2005 14:53  
**To:** Martin Crouch  
**Cc:** Rutherford, David; Sutherland, Jim  
**Subject:** RE: Losses investigation

Martin,

Please find attached my reply to your letter of 29 November, a hard copy will follow.

I also attach for your review a detailed overview of the methodology for deriving losses, as we have previously discussed. I would be grateful if you could confirm that you are happy with this paper as a statement of method.

We have also considered within our team the question of licence modifications as prompted by our previous discussions. Our deliberations would lead me to conclude the following:

- Regarding the restatement of units distributed and revenues prior to 1 April 2005 I believe that no licence adjustment is necessary. Special Condition B1(5) provides for components of the correction factor for 2005/06 to be calculated in accordance with the price control condition in force as at 1 April 2004.
- Regarding changes to the losses targets (the ALP term) I believe the only licence modification required is to amend Annex A of special Condition C1 to change the value of ALP in respect of 2005/06. Changes to ALP applicable from 2006/07 onwards are covered by the provisions in paragraph 7 of C1, which involve the licensee's consent.

06/12/2007

I would be grateful if you could confirm that you are in agreement with this.

Many thanks,  
Scott

-----Original Message-----

**From:** Martin Crouch [mailto:Martin.Crouch@ofgem.gov.uk]  
**Sent:** 29 November 2005 14:50  
**To:** scott.mathieson@scottishpower.plc.uk  
**Cc:** David Gray; Colette Schrier  
**Subject:** Losses investigation

Scott,

See attached letter as you requested yesterday. A hard copy will follow by post.

I understand from our conversation that you will reply tomorrow - please let me know if that will not be possible.

Thanks  
Martin

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