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15<sup>th</sup> April 2009

Dear Paul

**Electricity Distribution Allowed Loss Percentages – Representation by Scottish Power Energy Networks**

1. Please find attached a response on behalf of Centrica, in relation to the above consultation dated 3<sup>rd</sup> March 2009. This response is sent on behalf of the Centrica group of companies, excluding Centrica Storage Limited.

**Summary**

2. Centrica fully supports Ofgem's stance to reject Scottish Power's request for a re-opener in relation to the allowed loss percentages (ALPs) given that the revised ALPs were the result of a compromise agreement to close the formal investigation launched in March 2005. Should Ofgem accept Scottish Power's re-opener Centrica would wish to see the formal investigation re-opened and concluded.
3. As Scottish Power were in a position to know about the units connected at the EHV Transmission system and bring it to Ofgem's attention for DPCR4 Centrica does not support backdating the adjustment.

**Higher Allowed Loss Percentages**

4. Centrica strongly supports Ofgem's minded to rejection of Scottish Power's request for a re-opener in relation to the losses incentive and urges Ofgem not to change its position. The targets were set with agreement from Scottish Power, which it could have withheld if it thought the targets were inappropriate. Furthermore, from Ofgem's document it appears that while Scottish Power's target was set differently to other Distribution Network Operators (DNOs) there was a very good reason for this, as it was the result of a compromise agreement to close the formal investigation that had been undertaken into how Scottish Power was reporting its losses information.
5. The issues raised regarding BSC Audit qualification, level of reportable losses and subsequent Trading Issue 34 do not constitute a material change in the quality of information used by Ofgem in arriving at the revised ALPs.

6. Were Ofgem to accept the re-opener request it would also be appropriate to re-open the decision not to continue and conclude the investigation.
7. The rejection of this request for a re-opener reinforces an important principle that price control settlements are a package and sometimes companies may do less well than they expect for aspects of the price control, but that is no reason to allow additional revenues.
8. Given that Scottish Power's actual losses have increased, the fact that it has incurred losses under the incentive is a demonstration that the incentive for Scottish Power has worked appropriately. Therefore, Scottish Power has not been treated harshly, but instead the other DNOs have been treated too generously. Furthermore, if Ofgem was to allow this request from Scottish Power, then Centrica would argue that it should re-open the rewards earned by the other DNOs and claw them back, particularly where DNOs have earned rewards even when actual losses have increased.
9. Scottish Power makes the point that some of the rewards earned by other DNOs may be undeserved. We trust this will be taken into account by Ofgem when new losses incentives are set as part of DPCR5. However, although we agree this is the case, in the interests of the end consumers who ultimately pay for these incentives, there is no reason to add Scottish Power to the list.

#### **Scottish Power Distribution Allowed Percentage Losses – EHV Units**

10. While we understand the reasons why the losses target would be different if customers had been appropriately classified between transmission and distribution we would urge Ofgem to consider carefully whether any allowance for this should be made to Scottish Power during the current price control, as a minimum there should be no back dating of an increase in revenue.
11. As Ofgem notes Scottish Power could reasonably have highlighted the issue during the price control review, and we assume Scottish & Southern Energy did take account of the issue so have not needed to request a subsequent re-opener. Customers should not pay for management shortcomings of this type; there is a clear asymmetry for customers because a company would be unlikely to highlight a misclassification if that worked against it.

#### **Impact on Customers**

12. We understand that Scottish Power are asking for potential increases in 2009/10 of 4% in respect of adjusted ALPs, and for SPD an additional 3.6% for backdated transmission connected EHV-units - a total of £3.40 & £3.00 respectively per domestic customer. As context, these two networks have already published April 2009 average rate increases of 12-14%, and have recently been awarded costs under an ESQCR/TMA re-opener. Further cost exposure from the ALP adjustments would be incurred in future years.
13. In the recent ESQCR/TMA decision letter of 26 March 2009, Ofgem recognised that re-openers and cost adjustments have an impact on the end consumer which must be taken into account when deciding the timing of any rate increases. We agree with Ofgem's assessment that allowances of this nature should only be allowed in the current year to the extent that overall rate increases do not exceed 4% in real terms. We expect that the ESQCR/TMA recovery timescales, when published, will reflect this clearly set out principle (including an adjustment to any costs already factored into April 2009 rates).
14. Notwithstanding the strong views we have set out above, if Ofgem believe any additional allowances should be awarded to Scottish Power as a result of this consultation, they must take all relevant factors into account when determining the impact on the end consumer. Adjustments to allowances in the current year should only be made to the extent that additional

awards in aggregate for ESQCR/TMA + adjusted ALPs + transmission connected EHV-units do not cause overall rates to increase more than 4% in real terms. Treating the three adjustments separately effectively increases this boundary to 12% in real terms – this is not acceptable, especially in the current economic climate and at such short notice.

15. Centrica takes substantial price risk on distribution costs when we enter into fixed term contracts with our domestic and non-domestic customers. In response to customer demand, approximately 25% of our residential and 70% of our business customers have taken fixed products, and we have limited ability to pass short term network cost movements through to them. It is our strong belief that networks are better placed to manage many of these risks than we are – unpredictable network charges, especially in the short term, lead to higher risk premia. This is not an efficient outcome for the end consumer. We are particularly concerned that, in claiming back-dated transmission connected EHV-unit revenue allowances, Scottish Power are effectively increasing risks to suppliers. If network owners believe that any avoidable oversights or omissions made by them during a price control review can subsequently be claimed back from suppliers and customers – at short notice – many years later, this is bound to have an effect on their efforts to forecast accurately.
16. Hence, regardless of whether or not they are on fixed term contracts, all customers will ultimately suffer from Scottish Power's proposals – whether through direct pass-through of costs, or indirectly through higher risk premia. As the proposed substantial percentage increases apply to allowed revenue as a whole, this will impact on all classes of customer including the fuel poor. Any uncertain cost increases passed through at short notice can only serve to distort supplier competition, and may have particularly adverse impacts on smaller suppliers and potential market entrants.

### **Financial Consequence**

17. Scottish Power appear to be indicating that a consequence of not receiving the re-opener request is that its financial ratios might not be at a comfortable investment grade for at least one of its networks. Ofgem should make clear to Scottish Power, as it does in the consultation, that this is a matter for the shareholders to rectify, and not a reason for any increase in revenue for customers. Furthermore, if there is any suggestion that Scottish Power is failing to adequately spend to deliver the outputs it is required to under its licence as a result of the financial consequences of its losses performance then Ofgem should immediately investigate to ensure there is no negative impact on customers, and require Scottish Power to rectify any failures to invest at its owners expense.
18. Finally, Centrica would encourage Ofgem when resetting the losses incentive for DPCR5 to remove the provision that allows resetting of targets part way through the price control. Ofgem could then make very clear to DNOs when making its final price control proposals that acceptance of the overall package included acceptance of the losses incentive without subsequent possibility of the targets being reset.
19. If you require any further clarification please do not hesitate to contact me on 07789 571869 or e-mail at [paul.sherley@centrica.co.uk](mailto:paul.sherley@centrica.co.uk).

Yours sincerely



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