SP Distribution and SP Manweb (SP Energy Networks)

Response to Electricity Distribution Price Control Review (Methodology & Initial Results Paper)

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QUESTIONS POSED BY OFGEM

Chapter 2: Overview of FBPQ forecasts

Question 1: What are your views on the DNO cost forecasts presented in this chapter?

It is quite apparent but no surprise that the forecast increases in expenditure being sought by DNOs vary quite considerably.

The extent to which this is due to differing views on the impact of the economic downturn and the pace of recovery is not immediately apparent, although it is obvious that opinion is mixed on forecasts for load growth, units distributed and connections activity. Similarly there are wide ranging views on how input prices will behave during the DPCR5 period across both investment and operating activities.

Given the level of uncertainty we continue to support the development of appropriate revenue drivers to deal with volume uncertainty particularly in load related capex, and a balanced mechanism to deal with price uncertainty.

It is clear is that all DNOs recognise the need to step-up investment in core asset replacement in order to manage the risks associate with an ageing asset base.

The proposed increase in operating activities is significantly impacted by input price assumptions, as mentioned above, and by increases in workforce renewal. It would appear that the assessment of workforce renewal costs has not been carried out by DNOs on a consistent basis so it is difficult to draw any meaningful conclusions at this time.

Chapter 3: Operational cost assessment methodology and results

Question 1: Have we exposed the correct costs to comparative benchmarking?

Broadly yes, but we believe there is merit in factoring in how historic patterns of capex impacts current and future operating costs. We must highlight at the outset however that we have serious concerns about the validity and use of the cost drivers in the analysis so far. This is discussed in detail under Question 2.

We note that the results of the efficiency analysis are heavily impacted by the exclusion of certain costs. Unsurprisingly, DNO's that have a higher value of cost exclusions appear to have higher efficiency scores compared with a total cost comparison. This difference between companies with high and low cost exclusions would seem to have a larger than expected impact on the final efficiency scoring published by Ofgem.

Question 2: Do you agree with the assumptions we have made for our core analysis?

No, we feel the analysis has certain fairly fundamental flaws. It seems clear that the lack of independence of the scale variable against which costs are regressed fundamentally undermines the analysis.

It is unfortunate that after very lengthy consultation on some of the detailed consideration around e.g. cost exclusions, the efficiency model was only released relatively close to the publication of the Initial proposals leaving limited time for re-work.

Whilst we understand that other DNO's have other reservations of principal with the analysis our own is easily observed from the relative scale of SP Distribution and SP Manweb suggested by the analysis undertaken so far. At DPCR4 the CSV dominated by network length, whilst crude, but arguably wholly independent of cost showed SP Distribution to be of considerably larger scale than SP Manweb. The current analysis suggests that this position has reversed and that SP Manweb is of larger scale than SP Distribution and further that the relative scale varies considerably depending on which year is analysed. The analysis suggests there are marked movements in the relative size of all DNO's over the three years considered (over 25% in some cases), which is counter-intuitive.

During discussions at working groups and most recently at a 2007/08 RRP cost review presentation, we have highlighted the importance of cost drivers that are independent of cost or policy. We believe that number of assets, length of network and its physical characteristics and number/ density of trees are all true, independent scale indicators and therefore cost drivers. We believe that the current scale variable is too heavily influenced by cost or policy which may themselves embody efficient or inefficient practice. As such the analysis becomes circular.

The movements in efficiency over time appear to be dominated by the movements in the scale of the DNO's, rather than changes in the costs. The approach appears to over-emphasise unit cost measures at the expense of overall efficiency, which may be attained by undertaking a smaller volume of work but focusing effort in a more effective way. There is no assessment of whether these should increase or decrease during DPCR5. We are unclear how what is effectively an assessment of unit costs will be converted into a deemed efficient level of expenditure as this requires an assumption about the efficient volume of work.

We take some comfort from the fact that Ofgem during recent discussions have acknowledged some of these anomalies but we must urge that this analysis is reconsidered before publishing initial proposals. As indicated at the June cost bilateral we are currently undertaking our own analysis consisting of a top down regression on an aggregated cost data set with a CSV that reflects a truer measure of network scale. This analysis will be provided to Ofgem at the earliest possible date prior to publication of the Initial Proposals.

Aside from the issues of principle above, we would also highlight some apparent technical flaws.

- The correlation observed for single groups is so low as to have little statistical relevance, R squared is typically in a range of 0.3 – 0.6. This would suggest a lot of unexplainable variation in the numbers.

- As stated in previous correspondence and working group discussions with Ofgem, we do not believe that individual cost regressions are helpful in measuring overall efficiency. Regression analysis undertaken by Ofgem provides outputs that do not reflect known costs and differences.

- The functional form assumed in the analysis is inappropriate and disadvantages mid-sized DNO's, which consequently appear to be less efficient. A more flexible functional form is required to fit the data. We recommend use of the "translog" (transcendental logarithmic) function, which is quadratic in logarithms and is a second order approximation to any well-behaved function. This is widely used in the academic literature to model cost and production functions.

- The wide range in efficiency scores raises questions of comparability and statistical validity; some DNO's appear more than 5 times more efficient than others e.g. SSE Hydro compared with CN West on Cable Faults.

We believe that further work is required to reconcile these results with the approach adopted at DPCR4, since there are significant differences between the DPCR4 CSV and the proposed overall CSV for DPCR5. This brings into question the principal of regulatory consistency where the objective of assessing relative efficiency has not changed but the methodology and results clearly have. We look forward to proactively working with Ofgem on this in the coming months.

Question 3: What are the appropriate costs drivers for each of the cost groupings?

As mentioned above we will work with Ofgem in the coming weeks and months on refining the methodology. Fundamentally we wish to enhance the independence of the scale variable where possible.

Question 4: How should we determine baselines for the costs excluded from comparative benchmarking?

We welcome the approach adopted by Ofgem for certain excluded costs to be subject to independent review by experienced consultants.

The approach identified for IT of benchmarking costs while undertaking qualitative reviews on both practices and systems would appear at this stage to be correct. We await the detailed findings of Mouchel in June, which Ofgem have indicated will be shared with the DNO's.

The approach identified for the Property cost review in assessing property costs; workspace deployment and workspace costs would seem appropriate to determine the correct revenue allowance allocation.

We would however caution against a one size fits all approach being implemented for either of these two reviews and would expect Ofgem and its consultants to ensure that the merits or otherwise of each DNO group and its suitability and/or alignment with Corporate strategy is considered during any benchmarking process. Other, indirect costs excluded from the comparative benchmarking should be subject to a bottom-up review of DNO assumptions by OFGEM. However, in our view insurance costs should be taken back into the regression analysis insofar that those DNOs who are prepared to pay higher premiums (for lower excesses) are likely to have lower "comparable" costs.

Question 5: How should we treat atypical costs in the price control settlement?

We believe that in general atypical costs should be included in relative efficiency analysis. It is difficult to accept that there are material costs that are so 'atypical', other than the acknowledged severe weather definition, that they should not be either exceptional items or completely absent from the regulatory accounts. Otherwise they are part and parcel of running a Distribution business and are perhaps more simply 'infrequent' than 'atypical'.

We anticipate that Ofgem would set an efficient cost allowance for exceptional weather events, similar to that applied in DPCR4 but recognising the increasing incidence of extreme events as indicated by the Met Office and DEFRA modelling.

Question 6: What weight should we give to the benchmarking relative to other considerations?

Given the concerns highlighted above we would caution against placing exclusive reliance on the benchmarking results published in the May methodology paper.

For the purposes of the Initial Proposals, so we urge Ofgem to undertake further work including validation against other modelling approaches. If time does not permit completion the Initial Proposals should be caveated strongly.

Chapter 4: Methodology – Core network investment

Question 1: Do you agree with Ofgem's approach to assessing core network investment allowances based on the wide range of evidence detailed in the chapter?

We are supportive of the general three-stage approach to setting allowances, provided that the following points are maintained:

- The holistic process must be transparent and fully visible to the DNOs at **all** three stages of the process through
  i) Initial modelling – where DNOs need to have full sight of Ofgem's models
  ii) DNO Feedback – where the decisions over which feedback is accepted is clear
  iii) Other Evidence – where the process for qualitative assessment is visible

- The process of allowance setting must be joined-up and consistent to ensure that:
  i) DNO outputs are aligned to volumes of "work allowed" by Ofgem
  ii) The scope of the "work allowed" is reflected in the unit costs
  iii) The unit costs can be achieved in the current uncertain marketplace

Question 2: Do you agree with the primary network general reinforcement modelling methodology that Ofgem has adopted for DPCR5?

We consider that the methodology for assessing primary network reinforcement has improved from that applied in DPCR4. However, we do see some limitations, which need to be improved upon to make it more reflective of the investment drivers in reinforcement.

It is our view that these improvements should comprise the following:

- Factors, which reflect the current utilization of equipment and not just growth throughout DPCR5. This should consider varying approaches to risk in this area
  i) e.g. for SPM, in our highly utilized interconnected network we have several schemes where we have been managing multiple high utilization and overloaded sites which have now reached an unacceptable threshold of loading that compromises security of supply
  ii) The model should be expanded to include network growth on the 'network hotspot' substations, (that have occurred prior to DPCR5), which waits for overloading to occur, prior to investment in reinforcement

- The model should consistently exclude the few large schemes that are required for security of supply, as opposed to network capacity (P2/6)

- It should also exclude the few schemes that are required to support installation of new Transmission capacity (or increased (Supergrid to) 132kV groups)

Question 3: Do you agree with the asset replacement modelling methodology that Ofgem has adopted for DPCR5?

The methodology for asset replacement modelling does have some limitations, which we consider, could be improved upon to make it more reflective of the investment drivers.

The approach to deriving asset lives within the model should be improved, as the "double measurement" of asset volumes to derive DPCR4 and DPCR5 mean ages from 2008/09 and 2009/10 is flawed. (DPCR4 uses 2005-2010, and DPCR5 uses 2008-2015, which double counts 2008/09 and 2009/10).

The establishment of an effective industry age profile, as the basis for DPCR4 (end March 2010), would improve upon the current model. This would allow clear differentiation between DPCR4 mean asset lives and DPCR5.

We consider that a "proportioning" of five years investment over seven years is unsuitable, as this does not reflect the risk alternating between different price control periods. The assumption that the average replacement profile can be maintained at the DPCR4 level (4.38) conflicts with Ofgem's overall methodology (4.33) for asset replacement modelling, as it does not allow for "what industry as a whole is planning to do in the future".

The existing methodology assumes that the oldest average lives between DPCR4 and DPCR5 should be taken, irrespective of the fact that the industry as a whole may require to move to shorten asset lives as a consequence of risk and condition.

It would be more industry reflective if DPCR5 industry average ages were adopted if the majority view of DNOs was reflected as they are in the best position to reflect the risk, condition and performance of their ageing asset base.

Question 4: Is the outlined process for developing Initial Proposals suitable?

We believe that the outlined process for developing initial proposals is suitable provided that the points raised in questions 1-3 above are adopted and information on unit cost benchmarking, which includes both the scope and the market cost assumptions is reviewed jointly between Ofgem and the DNOs prior to the publication of the initial proposals.

Chapter 5: Network investment - Environment

Question 1: Do you agree with our approach to assessing the forecasts of distributed generation, discretionary expenditure and losses and are there any other factors you think we need to take into consideration?

In terms of discretionary spend and losses investment as specified in the February FBPQ, it is appropriate for Ofgem to consider assessing the individual schemes, given the small number and the wide range of options tabled. Benchmarking is unlikely to be of any value until a common industry view or baseline is established. Given the variety of views tabled in this area, further work between Ofgem and the DNOs will be required to establish a common industry view.

We continue to be very supportive of Ofgem initiatives to expend and deploy new technologies onto the network and have embraced the IFI concepts and mechanism. We support Ofgem's intention to establish an Innovation Incentive, however our preference would be to modify the current proposals (as being discussed in the EWG) to consider our option (as specified in our response to the Jan paper). We would suggest that once the form

of the Innovation Incentive is established, then DNOs would be better placed to submit further suitable schemes.

With respect to distributed generation (DG), we disagree with the methodology used to calculate the average cost per kW of non-sole use network reinforcement to connect DG.

The £50/kW figure was derived taking account of the average cost of non-sole use connection assets in respect of DG projects, greater than 10MW prior the implementation of the distributed generation incentive mechanism (DGIM) in DPCR4. Therefore we would expect any comparison with FBPQ information to be drawn based upon the same principles, this is not the case as reflected in Table 5.1.

In determining the average cost per/kW, Ofgem have used only the use of system capex, which does not reflect the true cost of reinforcement in non-sole use assets and therefore not comparable with the £50/kW analysis.

Our own analysis concludes that the average £/kW to connect generation that compares with the original analysis used averages at £61 in SP Manweb and £78 in SP Distribution. This analysis was based upon projects that are greater than 10MW and required network reinforcement in non-sole use connection assets.

We would highlight that we are very supportive of the current DGIM and would not envisage any alteration to the existing arrangements given that it is too early to take any firm view on the average cost to reinforce the network as a consequence of the low number of projects connecting to the network than expected at the beginning of DPCR4. This trend however is changing and we expect to connect a greater number of projects towards the end of DPCR4 and across DPCR5.

In addition, we foresee an un-necessary complication in having schemes charged under two different incentive mechanisms should Ofgem make any alternation to the existing DGIM.

Chapter 6: Ongoing efficiencies and input prices

Question 1: Have we identified the most relevant unit cost and productivity measures from other sectors to help inform our ongoing efficiency assumption for DPCR5?

We are aware that a number of detailed studies have been undertaken to estimate the potential for productivity improvements in the water, gas and electricity sectors in recent years, in both the UK and abroad. Reckon's analysis for the GDPCR has been superseded by further work by them in the water sector. Furthermore, the work undertaken by Ofgem's consultants at the GDPCR was subject to criticism by other consultants.

Ofgem's own analysis falls significantly short of best practice and cannot be relied upon to provide unbiased, robust results for electricity DNOs.

Question 2: When calculating these measures, which comparator sectors and time periods should we focus on?

Ofgem highlight a small number of sub-sectors from the EU KLEMS dataset, which, unsurprisingly, display a wide range of figures.

No explanation is given for the choice of these comparators and no formal statistical analysis (such as cluster analysis) has been referred to, which would indicate the degree of their similarity or dis-similarity to electricity DNOs. In particular, we would not expect manufacturing sectors to be a useful comparator for the technologically mature and relatively labour intensive operations of electricity DNO.

Furthermore, Ofgem would effectively double count the cost-savings from productivity improvements, as these are already reflected in the input prices that DNOs pay for materials and equipment. In addition, Ofgem appear to have omitted the broader finance, insurance, real estate and business service sector that is relevant to DNOs indirect and support costs.

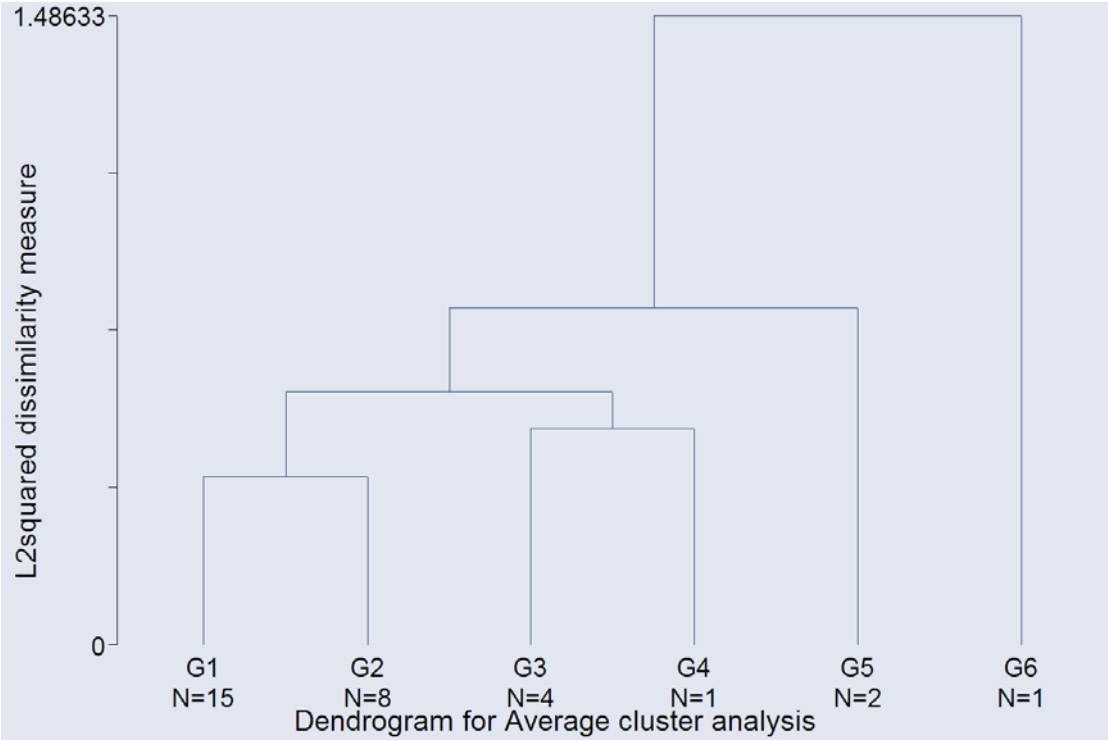
Candidate sectors or clusters thereof should be formally assessed for the degree of similarity or dis-similarity with electricity DNOs, using an appropriate statistical technique. No reliance should be placed on subjective selection of comparators.

Reckon's recent report[1] from Ofwat concludes :

"The main thing we take from the cluster analysis is the view that, of the 30 industries examined in this section, none of them are particularly similar to water or sewerage"

We have undertaken our own cluster analysis on the EU KLEMS data-set and similarly conclude that none of the industries are similar to electricity DNOs. As illustrated in the dendrogram, the "Electricity , Gas and Water Supply" sector appears in cluster group 5, alongside "Coke, Refined Petroleum and Nuclear Fuel", which reflects the association of fuels with generation rather than distribution. None of the other sectors are similar to electricity.

[1] Reckon (2008) "PR09 Scope for Efficiency Studies", Final Report for Ofwat, 17 October, Page 88, paragraph 4.132



It is well known that productivity is pro-cyclical. In the current macroeconomic climate, a trend rate of productivity improvement will overstate the potential for that achievable through what is already the deepest recession since the Second World War. Indeed, no recession of such severity has been experienced over the period, 1970-2005, for which data is available in EU KLEMS.

In any case, the data prior to 1990 is of much less relevance as industrial sectors and technological developments have changed greatly in the last few decades. For example, the share of manufacturing in the UK economy has declined markedly, whereas that of the service sector has become dominant. There have also been substantial changes in the labour market. Furthermore, investments in information technology and communications (ICT) have become much more important as enablers of productivity improvements but these are much more difficult to measure accurately. Consequently, apparent productivity improvements may have been overstated, as ICT inputs have been underestimated.

Question 3: What weight should we give to this analysis relative to other information?

For the above reasons, we find it impossible to draw meaningful conclusions from the selective data which Ofgem present. Therefore, little weight should be placed on the analysis presented.

No evidence has been presented that supports the assertion that UK electricity DNOs should be expected to deliver productivity improvement above that for the UK economy as a whole. Indeed, some twenty years post privatisation and continuous incentive regulation we would not expect to find any.

Question 4: What method should we use for setting our input price assumptions for DPCR5?

As Ofgem's own consultants acknowledge, there is considerable uncertainty about the future of input prices. At present, the depth and duration of the economic recession are unknown, as is the timing and speed of the subsequent recovery.

We propose that forecasts for input prices are updated in the autumn to incorporate the latest available information at that time.

Chapter 7: Customers

Question 1: Do you agree with the proposed mechanism (in full) for worst served customers?

Consistent with our submissions for DPCR4, we strongly support the greater focus being afforded to worst served customers. We welcome Ofgem's recognition of the need for investment targeting this important group of customers, however we consider that Ofgem's proposal do not go far enough.

We support Ofgem's proposal to identify worst served customers as those experiencing a minimum of three interruptions per annum in addition to the requirement that the customer has experienced fifteen or more interruptions over at three-year period.

We acknowledge that Ofgem are proposing to set a Capex allowance for each DNO to target improvements for worst served customers however, the proposal that this investment is to be logged-up and, subject to performance improvements being visible, recovered during the next price control period whilst attracting normal rate-of-return does give us cause for concern as this investment stream may not be considered attractive for DNO shareholders.

A more attractive investment proposal would Ex-ante allowance with claw back or for Ofgem to reflect the risk related to the requirement for performance improvements to be visible through an enhanced rate-of-return on this investment. Alternatively we believe Ofgem should remove the requirement for performance improvements to be visible from the recovery of investment in DPCR6.

Question 2: Do you agree with the proposed approach (in full) for setting unplanned targets for customer interruptions and customer minutes lost?

We support Ofgem's proposals as set out in the May consultation paper, in full, for the setting of DPCR5 performance targets and incentive rates. In doing so we acknowledge that Ofgem have addressed the shortcomings that, through discussion with the industry, have been identified in the process used to set DPCR4 performance targets.

We believe that Ofgem and the DNOs should continue to work together to review, and if necessary, develop or improve, the benchmarking process for use in future price controls.

Question 3: Do you think that we should set a cap on the cost per benefiting customers within the worst served customers mechanism and, if so, what level should this be set at?

Our experience to date in addressing worst served customers demonstrates that the solutions required would not normally withstand scrutiny by standard investment appraisal techniques since the cost per customer can be very high. As a consequence we believe that, for DPCR5, Ofgem should not set an upper threshold for the allowed investment aimed at improving the service for a worst served customer since this will effectively result in some worst served customers being deemed too expensive to deliver an effective solution. We would therefore propose that Ofgem require DNOs to use the allowance to ensure that it is invested effectively to deliver the best service improvements for their worst served customers and report retrospectively how the allowance has been used to their benefit.

Chapter 8: Network output measures

Question 1: Is Ofgem's proposed methodology for general reinforcement and asset replacement outputs appropriate?

We agree with Ofgem's approach that outputs should be focused on the larger areas of expenditure, forming asset replacement and reinforcement (78% of core investment).

We also agree strongly that the mechanism around outputs needs to provide some flexibility for DNOs to reprioritise the target HI and LIs where this is demonstrably in customers interests. For example, reprioritisation may be appropriate if levels of demand outturn at very different levels to those assumed in the DNOs business plans. We also support that Ofgem, working with DNOs, needs to do further work consider:

– if and how new or improved information, e.g. about the deterioration rate of a particular asset, will be used to adjust the target outputs, and

– if and how unforeseen external events that impact the DNO, e.g. major changes in government energy policy, are taken into account.

Question 2: Is Ofgem's proposed approach for other areas of investment appropriate?

We support Ofgem's view that there is currently not enough value to be gained in widely deploying output measures further across all the investment programmes (other than asset replacement and reinforcement), as the bureaucracy and administrative overhead for both Ofgem and the DNOs would not deliver value for customers.

Question 3: What approach should be taken if a DNO fails to deliver the agreed outputs i.e. how could the incentives be adjusted?

A possible approach would be to adjust the capital expenditure incentive-sharing factor, which would have applied under the IQI mechanism. However this would introduce uncertainty to the outcome of the IQI mechanism, which may be counter-productive.

On balance, we prefer an adjustment to allowed revenue for DPCR6, which would allow a more thorough assessment of the reasons for any apparent shortfall in outputs. The details of the mechanism should be set out in a Special Licence Condition, a draft of which should be made available at the time of the Final Proposals. We envisage that the approach detailed in Special Condition J7 of SP Transmission's Licence could be amended and developed to provide a formal basis for such an adjustment.

Question 4: Do you consider that the output measures proposed provides sufficient protection in their own right, or is it appropriate to have some from of additional safety net in the DPCR5 settlement, for example through monitoring investment volumes?

We do not believe that there is a need for a safety net, as in addition to the Output measures, Ofgem has full visibility of asset movements (input measures) already annually reported through RRP.

Question 5: Should there be an obligation on DNOs to further develop output measures during DPCR5?

We support Ofgem's approach to tier 2 output measures in DPCR5 and possibly a tier 1 measure in DPCR6. We do not see the need for formal licence conditions and see greater value in a voluntary approach to improve asset management with the other DNOs and Ofgem rather than a forced industry position.

Question 6: We seek views from stakeholders on the role that outputs should play in DPCR5 and particularly how they can best be implemented and used.

Feedback from our own stakeholder engagement throughout the course of the current price control and as part of the DPCR5 planning process, has confirmed support for our investment programme to deal with network capacity issues and to improve the security and reliability of supplies.

Chapter 9: Cost incentives

Question 1: Do you agree with our proposed approach to equalising incentives?

We agree that the proposed approach would reduce the potential distortions that arise from boundary issues. However, we would acknowledge that some distortions are likely to persist with the proposed approach, as incentives are not fully equalised across all expenditure.

Question 2: Have we identified the most appropriate costs to be within the equalised incentive and IQI?

We remain unclear as to how the proposal to include network operating costs with the IQI mechanism fits with the cost comparison and ongoing efficiency analysis that Ofgem are undertaking.

Question 3: How should we set the "RAV additions percentage" that will determine the split between "slow" and "fast" money?

We would expect the 'RAV additions percentage' to be set close to that which applied for DPCR4, subject to financeability. We are of the view that there must be some considerations of the link between RAV and fixed asset additions per statutory accounting rules. We understand that the RAV is a regulatory construct but the idea of fast and slow money should be aligned to the accounting and economic theory that underpins UK GAAP treatment. Any market reduction in RAV values from a reduction in the 'RAVable' portion should be avoided as this would lead to a deterioration in financial ratios and increase the risk of asset impairments.

Chapter 10: Managing uncertainty

Question 1: What balance should we adopt between mechanisms to manage specific risks (such as input price uncertainty) and a more general type of reopener to manage a wider basket of risks?

The number of specific mechanisms should be limited and focused on those areas that are outside the control of the DNO and where the impact could be material.

As specific mechanisms can only be developed for risks that have been foreseen and appropriately calibrated, there is need also for a more general re-opener. However, experience in other sectors such as water, shows that investors require greater certainty about the operation of the so-called "shipwreck" clause. Currently, DNOs would have to rely on a request to dis-apply the price control, which is an untried procedure with potentially uncertain outcomes.

Question 2: What risks should be covered by specific mitigation mechanism, by a general type of re-opener, and which should be left to the DNOs to manage?

Specific mechanisms should be developed to address input price and volume uncertainty. As discussed later we are in broad agreement with Ofgem's thinking around a taxation trigger.

The development of output measures fundamentally changes the regulatory contract and will limit the ability of DNOs to manage input price increases by rescheduling investment. We believe that risk sharing would offer the best balance of protection for customers and shareholders. This should take the form of a trigger mechanism, where indexation would apply outside the bandwidth for triggers. This would provide an appropriate degree of protection to both customers and DNOs, at the lowest overall cost.

We support the development of more appropriate revenue drivers to address volume uncertainty in an area such as load-related capex and agree that revenue drivers should be developed for connections and reinforcement. In addition, there is possibly a requirement to develop a mechanism to adjust for the volume of rising mains replaced given current uncertainty.

We consider that there should be a generic re-opener mechanism for changes to legislation or mandatory obligations that lead to a material change in the costs that DNOs face.

Question 3: Are there any additional risk mitigation mechanisms that we should be considering that are not identified in this chapter?

Chapter 11: TAX

Question 1: Is the approach to modelling DNOs capital allowances on a common basis representative of the industry position and does it ensure that no individual DNO is materially advantaged or disadvantaged by this methodology?

We have no objections, in principle, to the distinct allocations as this should replicate more closely the actual cash tax liabilities of the DNO's. However, we will need to understand how the percentage cost allocations in table 11.1 (Cost allocations to capital allowances pools) have been derived from the detailed allocations provided in table 8 of the FBPQ. Specifically we will seek justification of any moderation by Ofgem's "view of where capex should go according to the standard tax rules".

However we consider that the opening tax pools brought forward from DPCR4 should be based on the methodology adopted in the DPCR 4 model i.e. a generic approach was adopted in respect of allocations to pools and regulatory (as opposed to statutory) cost allocations were adopted and this is unlikely to mirror the DNO's capex profiles and capital allowances per submitted corporation tax computations.

If the opening TWDV's adopted in DPCR5 were based on the submitted tax return, then this could lead to double counting of allowances – not just a timing difference. We would suggest that it would be logical that the opening TWDV's in DPCR5 are the closing TWDV's per DPCR4 (amended to reflect actual DPCR4 additions and adopting the generic DPCR4 allocations to pools). This suggestion for determining the opening TWDV for DPCR5 will ensure consistency with the DPCR4 approach to calculating allowances and ensure that the tax allowance in DPCR 5 is fair and equitable and will avoid a tax deduction being given twice for the same item of expenditure.

We are strongly of the view that properly dealing with closing and opening TWDV balances which differ as a result of the move to an new approach is an essential component of that transition. We believe that this can be achieved without an ongoing requirement to maintain separate regulatory tax accounts, which would be cumbersome. For the avoidance of doubt we have no issue with the methodological transition in principle and are in no way suggesting that it was unexpected by the DNOs.

More detailed comments on the tax methodology are included in Appendix 1.

Question 2: Views are invited on whether the most appropriate option for the tax treatment of re-openers is the case-by-case approach.

We agree with the proposed tax treatment of re-openers in respect of corporation tax changes that are outside the control of both customers and DNOs. We agree that the mechanism should be symmetric.

We agree that the scope of the mechanism should include "any change in legislation that alters the cash tax charge for the DNO in the current price control period, and should specifically include changes in the relevant legislation whether introduced in a Finance Act, other Act of Parliament, Statutory Instrument or other legislative instrument" (para 1.31 of Appendix 14). We also believe that the scope should include "changes in, or clarifications to, HMRC interpretation of legislation" (para 1.31 of Appendix 14) – these are the rules that HMRC will apply when determining DNOs corporation tax liabilities and therefore these will pass the measurability and transparency tests.

We agree that where a number of changes are enacted at the same time, those changes should be considered in total as a single adjustment rather than separately; the phrase "the same time" should be defined as when the trigger event occurs – we agree that this should be the date upon which the tax change came into effect. To ensure that the number of tax change adjustments are minimised, we suggest that all tax changes (whenever they were enacted) that become effective on the same trigger event date should be considered as one change.

Question 3: Should the DNOs retain the risk and rewards for all amounts below/above the trigger threshold; or for the entire amount rather than the excess over the materiality trigger; and what should be the appropriate timing of adjusting revenues following both single and multiple triggers?

We believe that 100% of any changes should impact revenue therefore prefer no trigger threshold all. However, for pragmatic purposes, to avoid the requirement to react to very immaterial trigger events, we would accept that a trigger threshold of no higher than 0.5% of the average annual base revenue may be practical. Putting this in perspective, based on average base revenues in DPCR4 a 0.5% trigger would equate to a range across all DNOs of £0.9m to £2.0m per annum or £4.5m to £10.0m over all 5 years (all in 2007/08 prices). We believe that these levels are approaching significant sums for which both customers and DNOs would expect adjustments to be made around this level of materiality..

Should the DNOs retain the risk and rewards for all amounts below/above the trigger threshold; or for the entire amount rather than the excess over the materiality trigger?

Our view is that, whatever the level of trigger threshold, once breached the full value (not just the excess over the materiality trigger) should be adjusted. Since there was no risk perceived at DPCR4 in respect of tax changes we believe that this approach has no incremental impact to overall risk of the Price Control package compared with DPCR4.

What should be the appropriate timing of adjusting revenues following both single and multiple triggers?

As noted in paragraph 1.42 of Appendix 14, DNOs pay their tax liabilities 50% in the current year and 50% in the next tax year. To ensure that neither DNOs nor customers are penalised unfairly, we believe that option 3 of paragraph 1.44 of Appendix 14 is the most equitable solution i.e. “adjust in the regulatory financial year following the trigger event” – we suggest modifying this slightly by applying an interest adjustment (consistent with that in the quality of service incentive) but only half of the interest adjustment to reflect the 50:50 timing of tax payments thereby ensuring that customers and DNOs get the correct total adjustment to revenue.

We believe that there should be multiple re-openers and revenue for each re-opener should all be adjusted in accordance with the approach in the preceding paragraph.

We do not agree with any of the other four suggested approaches in paragraph 1.44 of Appendix 14 as these do not adjust revenues for customers and DNOs to reflect the actual timing of the tax payments.

Question 4: We invite views on the practicality of communicating the likelihood of a trigger being activated and the methodology for it.

In respect of communication we believe that notification to Ofgem alone should be sufficient as Ofgem act on behalf of customers. Communication to customers would occur through the charges notification process once the amount of any tax adjustment to revenue has been agreed with Ofgem.

Appendix 1

Comments on Taxation methodology statement (Appendix 14 of May Paper)

We appreciate Ofgem's efforts in working towards a revised tax methodology that more accurately reflects the DNO's actual cash tax liabilities. We are in agreement with much of the methodology. We have only commented on the areas where we have concerns or where the tax methodology statement requires clarification.

Applicable tax regime

The abolition of IBAs was announced in the Chancellor's Budget of March 2007, however the required legislative changes were not introduced until the Finance Act 2008. Therefore, whilst we note Ofgem's policy of applying the UK standard tax rules that have passed into legislation at the time of the final proposals, we will seek Ofgem's confirmation that any announced proposals that still await legislative change will subsequently qualify for the tax adjustment mechanism once the required legislation has been passed.

Modelling of capital allowances

We note as shown in Table 1 in Appendix 14 the cost allocation to capital allowances pools and the fact that DNOs not party to the non-load agreement will have their own cost allocations. As you are aware, the ScottishPower DNO's have never been party to the non-load agreement. We do not have any objections, in principle, to the distinct allocations as this should replicate more closely the actual cash tax liabilities of the DNO's.

We do however have some concerns and comments.

Firstly, we wish transparency regarding the percentage allocations as per Table 1 and trust that Ofgem are willing to demonstrate how the percentages are derived from the detailed allocations previously provided by the DNO's. This transparency should highlight if the actual allocations provided have been moderated by Ofgem's "view of where capex should go according to the standard tax rules". We consider that we correctly apply tax legislation, our treatment is accepted by HMRC and we would request justification of any moderation that is suggested.

Secondly, we note that the allocations in Table 1 are at a very high level. In view of the fact that the DNO's provided allocations information at a detailed level, we would suggest that this information is used to allocate additions. This would more accurately reflect actual allocations that may vary depending on the mix of expenditure within each high level block.

We imagine that actual capex and opex in the final proposals will be different to that in the FBPQ. Therefore the cost allocations to the capital allowances pools (table 1 of Appendix 14) will need to be revised to reflect the final proposals mix of expenditure.

Thirdly, operating expenditure that is treated as capital for tax purposes but opex in the regulatory framework will need to be added back in the tax computation, on the assumption that the computation starts from regulatory profit. We would envisage this working by identifying the total capex additions per the regulatory framework and comparing with the capex treated as capital for tax purposes (per Table F8A) and the difference being added back as a non allowable item in the tax calculation.

Finally, we will review the draft model prior to the tax meeting on 9 June 2009 and will comment at that meeting as necessary.

Opening capital allowance pool balances

We note the comment that the opening tax pools brought forward from DPCR4 will have been calculated based on the licensees' own accounting policies/tax rules – we understand this to mean that the pools will be based on the submitted corporation tax computations rather than the values per the DPCR4 model.

However we consider that the opening tax pools brought forward from DPCR4 should be based on the methodology adopted in the DPCR 4 model i.e. a generic approach was adopted in respect of allocations to pools and regulatory (as opposed to statutory) cost allocations were adopted and this is unlikely to mirror the DNO's capex profiles and capital allowances per submitted corporation tax computations. The reasoning for this view is provided below.

We note the comment that in determining the values of the opening tax pools to be used for DPCR5, a logical starting point is likely to be the most recently submitted DNO tax returns. We do not consider that is the case due to the different methodology adopted in DPCR4. The following example highlights the issue.

Expenditure	DPCR4 allocation	DPCR4 allocation	Tax computation allocation	Tax computation allocation
	Opex £	Long life pool £	Opex £	Long life pool £
100	50	50	0	100
Tax deduction/WDA	(50)	(3)	0	(6)
TWDV c/f	0	47	0	94

If the opening TWDV's adopted in DPCR5 were based on the submitted tax return, then this could lead to double counting of allowances – not just a timing difference. In the example, the TWDV c/f of £94 will include £47 of expenditure on which a tax deduction for opex has previously been recognised in DPCR4. It would not then be logical to recognise a tax allowance, being WDA's, on this same expenditure in DPCR5.

The differences between the closing TWDV's in DPCR4 and the closing TWDV's per the submitted returns will be attributable to the differences in the regulatory tax allowance basis in DPCR4 compared with the submitted computation basis based on statutory accounts.

We would suggest that it would be logical that the opening TWDV's in DPCR5 are the closing TWDV's per DPCR4 (amended to reflect actual DPCR4 additions and adopting the generic DPCR4 allocations to pools). This suggestion for determining the opening TWDV for DPCR5 will ensure consistency with the DPCR4 approach to calculating capital allowances and that the tax allowance in DPCR 5 is fair and equitable and will avoid a tax deduction being given twice for the same item of expenditure.

We also note that opening pool balances are subject to any adjustments you consider appropriate. We do not consider it appropriate for Ofgem to make an unilateral adjustment to balances other than to take into account non 31 March period ends. We request transparency regarding any such adjustments that are proposed.

You had previously noted that you would discuss and agree opening tax pools with DNOs and trust that this is still the position and will be arranged in due course.

Capitalised indirect costs

We welcome the proposal to amend the treatment from the RAV rules applied in DPCR4 to the DNO's actual treatment of indirect costs. We request transparency regarding the attribution to capital allowances pools.

Modelling the tax deductibility of pension cost

Ofgem have stated in paragraph 1.16 of Appendix 14 that the tax treatment at DPCR4 was that all cash payments by the licensee into a pension scheme are 100 per cent deductible in the year incurred. This is not correct in that there was spreading of pension contributions paid in DPCR4 and unrelieved pension contributions will therefore require spreading in the DPCR5 model.

We also request that Ofgem consider the position regarding the ScottishPower and other DNO's who capitalise a portion of pension contributions and obtain a computational tax deduction in the form of capital allowances. We would suggest that we discuss the position to clarify the actual tax treatment and the proposed modelling of pension contributions on a specific DNO basis.

Corporation Tax instalments

We note and agree with the comments in paragraph 1.24 of Appendix 14. This clarifies that all quarterly tax payments due to be paid in the five year DPCR5 period will be taken into account in the tax model.