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Regulation & Commercial

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Date
23 April 2010
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Dear David

**Transmission Price Control 4 – Scope of the "Adapted Roll-Over" (2012-13)**

This response is submitted by SP Transmission Limited as the regulated transmission business that owns and maintains the electricity transmission network in the south of Scotland.

Our main points are:

- The "adapted roll-over" should be proportionate and should not preempt the outcome of RPI-X@20;
- Investment stability is essential to ensure that delivery is not compromised;
- The current TPCR4 return should be maintained; and
- The period of time to prepare the FBPQ submission is too short. We recommend that this period should be extended by a month with a deadline of end November 2010.

In the appendix to this letter we have structured our response to address the questions raised in the consultation document.

Yours sincerely

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**Appendix**

**SP Transmission Response to Specific Questions Raised by Ofgem**

## Chapter 2

**Question 1: Do you agree with the objectives for the one-year "adapted roll-over" set out in this chapter? Are there additional objectives that should be included?**

Care must be taken such that the objective "to reflect recent developments in Policy" does not conflict with objective "to be proportionate to a one-year control and to minimise regulatory burden".

We believe that it is sensible to adopt certain generic measures introduced for DPCR5, such as the adoption of the tax trigger, and regulatory fractions for pensions deficits. However, any policy change that is not generic should not be part of the "adapted roll-over" ("roll-over"). That is, where policy needs to carefully consider or evaluate the transmission environment then such policy should be covered in TPCR5 and not in the roll-over

## Chapter 3

**Question 1: Do you agree with our intention to include TO and SO components in the one-year "adapted roll-over"?**

We agree that the roll-over should focus on determining allowances for the TOs.

**Question 2: Do you agree with the three options we have identified regarding the treatment of capex? Do you agree with our 'minded to' position i.e. option 2?**

In terms of proportionality and "regulatory burden", we believe that option 1 is the best option. Ofgem's main concern with Option 1 is inefficiently incurred capital expenditure resulting in "unjustified costs to customers". We believe that the likelihood of undertaking inappropriate expenditure is very low, and if this were to occur then this could be quickly resolved through appropriate adjustments at TPCR5 hence leading to minimal, if any, impact on customer costs.

We are concerned that Option 2, which includes a "limited investigation" of historical capex, could lead to a considerable proportion of our historical capex being reviewed. This would increase the "regulatory burden" and is not in our view proportionate.

The annual TRRP is intended by Ofgem to "facilitate effective monitoring of expenditure compared to allowances" and "inform future price control reviews". For any historic capex assessment we suggest that, where possible, the TRRP information is used first before referring to the Licensees for further information.

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Asset Modeling

We note from the recent stakeholder workshop that Ofgem intends to undertake non-load modeling. We would again question whether this is proportionate.

Whilst the usage of the new modeling techniques developed by Ofgem for DPCR5 would be effective and useful over the five-year period of TPCR5, it does not seem proportionate to apply this whole new set of techniques to a one year roll forward. In addition, as age based modeling requires typically a five-year data set to implement successfully it doesn't seem practical to implement for a one year roll forward. We would suggest that it is more appropriate to consider the individual proposed schemes for the roll forward year, within the context of the previous modeling carried out at TPCR4, which would have looked forward into TPCR5.

Unit Costs & Real Price Effects

We also note from the workshop that a general unit cost analysis will take place. We recommend that care must be taken here as our recent experience as part of the ENSG work is that there can be considerable variation between a consultant's view and our own. If a unit cost analysis is to be undertaken then Ofgem must commit to ensuring that any potential differences are thoroughly assessed.

**Question 3: Do you agree with the four options we have identified regarding the treatment of opex? Do you agree with our 'minded to' position i.e. option 3?**

We agree that a detailed assessment of engineering operating costs is not appropriate for the roll-over. We therefore support Ofgem's preferred option 3 where operating costs are rolled forward is based on the average of costs in the first three years of the control.

We hope that any company specific "efficiency factor" is not an arbitrary adjustment but is based on thorough analysis. In TPCR4 Ofgem identified efficiency savings of 1.5% p.a. but the analysis underpinning the derivation of this factor was never justified. We have a concern that a similar approach may be used in this roll-over.

**Question 4: Do you support our intention not to pursue new policy issues as part of the one-year "adapted roll-over"? In particular, do you agree with our position not to assess in the "adapted roll-over" those projects that were nominated under the Enhanced TO Incentives project?**

In March, Ofgem published an open letter setting out the process for managing funding associated with the treatment of ENSG reinforcement projects. We are content to keep this process separate from the roll-over.

**Question 5: Regarding revenue drivers, do you agree that no new regulatory incentives should be introduced and that the existing targets should be simply rolled forward with the exception of any adjustments to address areas where there has been significant misalignment between TPCR4 baselines and outturn values?**

We agree that new regulatory incentives should not be introduced. Given that this is a roll-over review, we recommend that existing targets should be rolled forward where necessary but any adjustments should be carefully assessed as part of a full review.

**Question 6: Do you agree with our 'minded to' position to extend the application of the existing network output measures methodology for the one-year "adapted rollover"?**

We agree with Ofgem's minded to position to extend the application of the existing Network Output Measures methodology for the one-year roll-over.

**Question 7: Do you agree with our 'minded to' position to restrict licence amendments to those required to facilitate execution of the "adapted roll-over" and for any rationalisation process to take place as part of TPCR5?**

We agree with Ofgem's 'minded to' position to restrict licence amendments to those required to execute the roll-over. Any rationalisation process should take place as part of TPCR5.

As we commented in our answer to Chapter 2 Question 1, where any quick and simple changes can be implemented, such as some of the generic measures from DPCR5, then Ofgem should consider incorporating these.

**Question 8: Do you agree with our proposals regarding the engagement of stakeholders? Do you have any suggestions for additional ways which we should pursue to improve stakeholder engagement?**

There was consensus at the recent stakeholder workshop that stakeholder engagement should be proportionate. We support this view and would question whether there is a need to initiate further workshops and/or challenge groups.

Although we are a TO with a contractual relationship only with National Grid, we are nevertheless actively involved across the industry in keeping all stakeholders informed on our plans and, in particular, on our progress on new connections and network reinforcements.

**Question 9: Do you have any further comments on the general scope of the one-year "adapted roll-over"?**

We do not have any further comments on scope. However, we would like to raise our concerns over the process for this roll-over.

We are concerned at the short period of time to complete the FBPQ. As the Licensees will be focusing on our TRRP through to July, Ofgem is effectively giving the Licensees only three months to complete the FBPQ (on the assumption that the FBPQ deadline is currently end October). We recommend that Ofgem extend this deadline to the end of November.

Given that it is intended for the roll-over to be proportionate, the second FBPQ should not be too detailed. We suggest that the Licensees should resubmit their FBPQ submissions to reflect actuals for 2010/11 and updated capital expenditure forecasts, to take in to account consenting progress and up-to-date tender prices.

## Chapter 4

**Question 1: Do you agree with our intention to use an enhanced version of the TPCR4 financial model following developments embodied in the GDPCR and DPCR5 models for the "adapted roll-over"?**

We support the development of the TPCR4 financial model for the adapted roll-over. We suggest that enhancements should focus on:

- Including any modeling of RORE;
- Modeling the impact of any proposed change in depreciation lives in advance of TPCR5, including a full historical RAV; and
- Assessing the financeability of the licensee using traditional financial ratios; and
- Including an option to include ENSG projects.

We would emphasise that the development of the DPCR5 model took many months of effort and that resources and timescales will limit what can be developed in time for the adapted roll-over. SP Transmission is committed to assisting Ofgem in developing the model.

**Question 2: Do you agree with our intention to use RoRE analysis for the "adapted roll-over" to ensure the package as a whole is appropriate?**

We support the development of RoRE, as a measure of the expected return to shareholders but believe it is unnecessary for the purposes of the adapted roll-over where the existing framework yields relatively little scope for out-performance of allowances.

If Ofgem intend to use RORE we would suggest that it is incorporated within the financial model to aid transparency and that any assumed out/ under performance is agreed with the network operators if this is to be used to in any way corroborate and or determine the allowed cost of capital in the event that Ofgem decide not to roll forward the existing cost of capital as we prefer.

RoRE itself is not a sufficient indicator of whether the overall package is appropriate, as it does not ensure that the licensee is financeable. In practice, financeability requires that the licensee maintains an investment grade credit rating. Furthermore, one of the key features of the regulatory ring-fence is the obligation to maintain an investment grade credit rating.

**Question 3: Do you agree with the three options we have identified regarding the treatment of the cost of capital and our 'minded to' position i.e. option 2?**

The cost of capital is a major component of the price control settlement and a full review of market evidence for each of its components should be undertaken for

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TPCR5. We do not think it would be proportionate to undertake such a review for one year.

In practice, the cost of capital is calculated from components that are estimated from data which spans a number of years. It would therefore be spurious to try and estimate the cost of capital for a single year.

Furthermore, previous studies have demonstrated that cost of capital estimates can fall within a wide range and it would be unclear what constituted an apparent movement in inputs which would be deemed sufficiently large to warrant a more comprehensive review. For these reasons Ofgem would not be failing in its duty to protect customers by simply rolling forward the existing allowed cost of capital.

We propose that, for the adapted roll-over, the overall allowed return is set at the level allowed previously for TPCR4, which would avoid the need for a review of individual components, at this stage. This should be sufficient to ensure that new capital can be raised to finance the rapidly rising investment.

**Question 4: Do you agree with the two options we have identified regarding the treatment of capitalisation & depreciation and our 'minded to' position for option 1?**

We agree with the proposal not to change the treatment of capitalisation and depreciation for the adapted roll-over. As capitalisation and depreciation are being considered as part of the RPI-X@20 workstream, it would be inappropriate to review formally at this stage.

**Question 5: Do you agree with the three options we have identified regarding the treatment of tax and our 'minded to' position i.e. option 2?**

We agree that option 2 is the most practical solution for the one-year roll-over. Consistent with the form of this calculation used in DPCR5 the allocation of costs to capital allowances should be company specific (as opposed to generic) because of the relative scale of the licensees.

We believe that it may be feasible as part of the adapted roll-over to develop a simple taxation 'partial pass through trigger' similar to that developed at DPCR5. This reduces the risk to DNOs and customers from material changes in tax legislation beyond their control.

**Question 6: Do you agree with the three options we have identified regarding the treatment of Pensions? Do you agree with our 'minded to' position i.e. option 2?**

We support application of the principles that were established, during DPCR5, for pensions. We believe it would be feasible as part of the adapted roll-over to agree regulatory deficit fractions in advance of the main price control review.

**Question 7: Do you have any further comments regarding financial issues for the one-year “adapted roll-over”?**

No