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Dear Rachel,

DPCR5 – review of process


SSE welcomes the opportunity to comment on how Ofgem conducted the recent distribution price control review (DPCR5).

We have attached our response to the questions raised in Attachment 2 of Ofgem's letter of 2 March 2010 and hope that these will be useful in helping to understand what could be improved and what should be done differently in future reviews. Overall, with one exception, we believe that the DPCR5 process was well run and fit for purpose. Our one area of concern relates to Ofgem's process for setting the weighted average cost of capital (WACC).

Ian Marchant wrote to Alistair Buchanan on 16 December 2009 accepting the final proposals in principle, subject to the detailed licence drafting reflecting policy intent. That letter also expressed concern over Ofgem's approach to setting the WACC and the fact that the first sight DNOs had of Ofgem's thinking was at final proposals. This was unacceptable by way of process. Prior to that, all that had been available was a wide range of possible outcomes (3.8% to 5.1%, post tax real) with no indication of a point estimate. For modelling purposes Ofgem used the DPCR4 cost of capital, a departure from previous price controls.

At the last distribution price control review (DPCR4), we saw a point estimate for modelling purposes from Ofgem from within a significantly narrower band as early as initial proposals. Indeed, at the most recent price control review, the gas distribution price control in 2008, we again saw a point estimate for modelling purposes at the initial proposals stage.

Notwithstanding Ofgem's use of 'return on regulatory equity' to help calibrate the balance of risk and reward in the final proposals, the WACC remains a crucial parameter in any price control settlement; it is the return required by investors in a business. Whilst we fully understand that the decision on the actual number cannot be made until final proposals, it is essential that a much clearer indication of Ofgem's thinking is provided, for the businesses and the City, at an early stage in the price review process. Ofgem has stated, and we agree, that there should be no surprises at



final proposals. For DPCR5, the level of the WACC came as a complete surprise to everyone in the industry and the City.

Historically, Ofgem has provided a point estimate from within a realistic range at initial proposals that allows all interested parties to model potential outcomes. As such we would urge Ofgem to return to providing a point estimate of the WACC at initial proposals for the next round of price control reviews (electricity & gas transmission and gas distribution).

If you have any questions on the above, or our attached response to the questions raised in the open letter consultation, please do not hesitate to call me.

Yours sincerely,

Malcolm J. Burns
Regulation Manager

SSE Response to Ofgem's 'Areas for Consideration'

1. Keeping you informed of the DPCR5 process

Generally, we felt that communication on the DPCR5 process was good.

2. Availability of Ofgem to those who had queries or concerns

Access to the project team and key staff was good, with a reasonable turn around time for any queries raised.

3. Writing accessible decision documents that explained the underlying rationale for Final Proposals

Whilst the price review consultation documents were clear on Ofgem's proposed policy (or on the options for policy development), too many decisions were left until final proposals. For future reviews we would urge Ofgem to ensure that key principles are established at a much earlier stage, e.g. WACC (as discussed in the covering letter) and pensions policy.

On a similar theme, the financial model was not 'locked down' until very late in the process and, for future reviews, we would urge Ofgem to have a firm model available much earlier.

4. Providing an opportunity for you to put your views across and influence the process

Overall we believe that there was adequate opportunity for us to put forward our case.

5. Planning the project and setting the timelines for deliverables and responses to consultations etc

With regard to responses to consultations etc, the process was good, with adequate time for responding. However, with regard to responding to many additional or *ad hoc* information request (e.g. TMA information), the turn around time for provision of information was extremely tight and in many cases unrealistic. It is essential that the regulated businesses are given adequate time to collate data for such requests.

6. Requesting information and the type, form and level of information

The amount of information requested during the price control review was significant, and much increased upon previous reviews. As noted above, on occasions the turnaround time requested for some information was extremely short.

Furthermore, it was extremely disappointing that the RRP pack was not used as the baseline for the financial business planning questionnaire (FBPQ). The RRP was designed during DPCR4 for exactly that role and was intended to reduce the amount of information to be requested at price control reviews. The actual FBPQ bore little resemblance to the RRP pack and was at a level of granularity that was unexpected (and unsignalled). Indeed, the overall FBPQ process was poor with the content continuing to change right up to a few weeks before the completed questionnaire was due. The connections worksheets were a particular problem in this regard.

Overall the increased level of information requested added a significant burden to our project team. For future reviews it will be essential to ensure that the type, form and

level of information to be requested are clearly signalled to the businesses well in advance of the project. This will be essential as we lead up to DPCR6 given the significant increase in reporting requirements already required as a result of DPCR5. We also believe that if Ofgem is not to use the RRP information in setting price controls, then the scope of the RRP pack should be much reduced, to the benefit of both Ofgem and the companies.

7. The level of resources we employed throughout to deliver the project

At times, particularly towards the closing stages of the review, some staff members appeared to be over stretched. This is perhaps symptomatic of large projects, but providing additional resources at key stages of a price review could serve to improve the overall process.

8. The number type and form of meetings, working groups and workshops

We believe that the number, type and form of meetings, working groups etc was suitable. However, we do believe that the Regulation Policy forum could have been used much more effectively to sound out and discuss emerging policy, e.g. RoRE.

9. Issues that may arise in light of our process in regards to implementing the finding of the RPI-X@20 project

The findings of the RPI-X@20 project will be first implemented in the electricity & gas transmission and gas distribution gas reviews. One key learning point from DPCR5 is that key policy decisions should be signalled clearly and early in the process.