SP ENERGY NETWORKS

Regulation & Commercial

Gareth Walsh
Ofgem (Smarter Grids and Governance Team)
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London
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Your ref

Our Ref

Date
13 May 2011

Contact / Extension
Scott Mathieson
0141 61 41612

Dear Gareth,

Consultation on TPCR rollover policy update and initial analysis of business plans

Thank you for the opportunity to comment on Ofgem's consultation on TPCR4 rollover update. I can confirm that this response is not confidential and can be published on the Ofgem website.

The key points which emerge from our attached response to the questions you raised are:-

1. We understand the concerns expressed by your consultants regarding the certainty of our load related forecasts, particularly their concerns about construction expenditure depending on resolution of consenting issues. However the removal of certain generation schemes altogether it is likely to raise concerns amongst the stakeholders we have engaged with.

2. We have revisited the cost of debt on a basis that is consistent with that applied at TPCR4 and find that there is no clear evidence to depart from the cost of debt. We reach this view by drawing upon observation of UK 5 year nominal yields, interest rate forecasts from Oxford Economics and an updated analysis of UK Corporate spreads.

3. It is widely recognised that a larger capital expenditure programme (relative to RAV) will increase risk. We therefore support the case for use of lower notional gearing for both of the Scottish TOs, whose capex for the rollover year is a substantially larger proportion of the current RAV than for National Grid.

Should you have any further comments please to do not hesitate to contact myself or Stuart Reid (0141 61 41959).

Yours sincerely

Scott Mathieson
Regulation & Commercial Director
SP Energy Networks

Attachment
Consultation on TPCR rollover policy update and initial analysis of business plans

ScottishPower Energy Networks response to your questions

CHAPTER Two : Policy

Question 1: Do stakeholders agree with our view that it is not necessary to allow any cost categories to log-up during the TPCR4 rollover year, but for forecasts to be included in the base allowances?

We agree with Ofgem that there is limited uncertainty in forecasting costs for a one-year rollover and, therefore, that there is no requirement to log up costs for the rollover year.

Question 2: Do stakeholders agree that it is appropriate to continue to pass through the current set of pass-through costs to consumers?

We agree with Ofgem that costs that are outside the control of the TOs should continue to be passed through to consumers during the rollover year.

Question 3: Do stakeholders agree that it is appropriate to make TO/SO adjustments in response to the gas revenue drivers on 31 March 2012 and 31 March 2017?

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Question 4:With respect to Milford Haven do stakeholders agree that it is appropriate to keep the £9.5m (2004-5 prices) downward adjustment to the TO allowed revenue but review the figure?

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Question 5: Do stakeholders agree with our view that no new electricity transmission revenue driver need be introduced for the TPCR4 rollover year?

Although there is some uncertainty over local infrastructure expenditure for the rollover year, we agree that this level of uncertainty is significantly less than existed when setting TPCR4. We therefore support Ofgem's pragmatic approach not to include any new revenue drivers for the rollover year.

Question 6: Do stakeholders agree with our start and finish date based approach to determining capex allowances for TPCR4 revenue driver projects during the TPCR4 rollover year?

We agree with the approach proposed by Ofgem.

Question 7: Do stakeholders agree with our proposal to maintain the capex incentive in the TPCR4 rollover year and keep the sharing factor unchanged at 25%?

We agree that it is appropriate to maintain the capex incentive in the rollover year and keep the sharing factor unchanged at 25%.

Question 8: Do stakeholders agree with our proposal to allow the capex incentive payment on a provisional basis for SPTL, SHETL and NGG, making any further adjustments as part of the RIIO price control?

We agree with Ofgem's proposal to allow the capex incentive payment on a provisional basis for SPTL, SHETL and NGG.

Question 9: Do stakeholders agree with our proposal to defer payment of NGETs capex incentive until we have performed a detailed assessment of projects regarded as WIP, and fully considered the impact of connect and manage and TO incentives?

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Question 10: Do stakeholders agree with our proposal to maintain the SO capex incentive for National Grid in their role as gas and electricity SO for the TPCR4 rollover year and keep the sharing factor set to ±25%? Do stakeholders also agree with our proposed approach to make a provisional revenue adjustment in 2012-13 in line with the SO capex incentive, and true this up as part of the TPCR4 rollover?

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Question 11: Do stakeholders agree with our proposal to maintain the gas internal SO opex sharing factor at ±40%, and align the electricity SO internal sharing factor with that used for incentivising external costs?

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Question 12: Do stakeholders agree with our proposed approach to leave the electricity reliability incentive scheme and its parameters unchanged for the TPCR4 rollover year?

We agree that it is pragmatic to leave the electricity reliability incentive scheme unchanged

Question 13: Do stakeholders agree with our provisionally preferred approach to continuing to incentivise a reduction in the leakage rate of SF6 gas, updating the target leakage rates to reflect performance during TPCR4?

We support Ofgem's approach to continuing to incentivise SF6 gas leakage for the rollover year.

We have explained to Ofgem that many of our older SF6 assets have design leakage rates of 3% and that new SF6 assets have a design leakage rate of 1%.

Although our actual SF6 gas leakage fell from 2.40% to 1.81% in 2009/10, our leakage rate increased to 1.89% in 2010/11. This increase supports our position that, unless we undertake significant investment to replace our known high leakage SF6 assets, it is not possible to improve leakage beyond current levels. We believe that Ofgem's proposed target for SPT of 1.23% for the rollover year is too low, and that it is reasonable to set a more realistic target at 1.5%. In principle we believe our target should be set at the same level as National Grid and an adjustment to 1.5% therefore aligns more closely with your proposed target for National Grid.

Question 14: Do stakeholders agree that it would be appropriate to maintain the default investment lead times for NGG at their current length?

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Question 15: Do stakeholders agree that it would be appropriate to give NGG the permit scheme payout in 2012-13 and extend the permit scheme for one year by pro-rating existing parameters?

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CHAPTER Three : Business Plan Assessment - Capex

Question 1: Are the forecasts put forward by the transmission companies reasonable given the significant increase over 2011-12 allowances and historical costs?

We believe that our forecast is reasonable and supported by an appropriate needs case. Our forecast base capex for the rollover is a 48% increase on the 2011/12 allowance.

This is driven by an 82% increase in load related investment required to facilitate connection of renewable generation in support of UK environmental targets.

Our non load forecast represents a 17% increase on 2011/12 and is driven by continuation of our conductor replacement programme agreed at TPCR4. The needs case for our non load forecast is based on detailed asset condition data and is aligned with our long term strategy as we move into RIIO-T1. Without intervention, 50% of our overhead line conductor and switchgear assets will be life expired by the end of 2018. Our non load forecast provides prudent investment for 2012/13 to manage the risks on these assets.

Question 2: Do you agree with our consultants" assessment of the TO" s forecasts?

The consultants have separately assessed load related and non-load related expenditure. In both cases we recognise the approach used by the consultants and believe it to be appropriate.

For load related expenditure the consultants have proposed reductions based on their confidence in the timing of generation connection schemes. We agree that the consenting and developing process impacts on the timing of these schemes and recognise there is some uncertainty as to whether they will all proceed on the current timescales. We believe that appropriate funding mechanisms should be provided to address this uncertainty.

For non-load related expenditure the consultants have proposed reductions in the areas of switchgear and overhead lines. The switchgear reductions are based on the consultants' belief that SPTL are accelerating work in advance of need. We believe that this is based on a misunderstanding of a project at Devol Moor substation and clarification of this issue should resolve this.

The overhead line reductions are based on concerns on the deliverability of the proposed programme. We recognise that forecast programme is a 46% increase on our delivery in 2007/08 and that this creates a challenge for the supply chain. However, we believe that reducing the forecast to 07/08 prevents SPTL from ramping investment in this area and expanding the supply chain to a level that will be required, and further expanded, during RIIO-T1.

The consultants have also applied uncertainty ranges to the forecasts for load and non-load expenditure. The volatility of load related expenditure is caused by generation connections. The application of the range is appropriate on this basis. However, for non-load there is no clarity on why the range has been applied. The needs case is not driven by external factors and the application of the range is not appropriate.

Question 3: Do you agree with our proposed "next steps" set out in this chapter?

We agree with Ofgem's proposed next steps and look forward to further discussions with Ofgem and their consultants.

Question 4: Do you consider there is a case for investment in network flexibility by NGG in 2012-13?

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CHAPTER Four : Business Plan Assessment - Opex

Question 1: Are the forecasts put forward by the TOs reasonable given the significant increase over 2011-12 allowances?

The forecast SPTL has put forward for controllable opex, at £19m is not much higher than the 2011/12 allowance (£18.3m in 2009/10 prices, and Ofgem's HIGH case), particularly given the upward cost pressures created by a growing and ageing asset base.

Question 2: Do you agree with our assessment of the TOs' forecasts?

In terms of the Opex assessment undertaken, the consultation document is very short on detail.

It is not clear to us how Ofgem's LOW case of £16.2m has been established but the implications of a 15% reduction, compared to existing allowances, for our business would be enormous and not acceptable.

Question 3: Should Workforce Renewal and Staff Recruitment be made a separate allowance from the general opex?

Ofgem provided DNO's with a use-it or lose-it allowance for workforce renewal costs as part of the DPCR5 package.

Given that the arguments made successfully by the DNO's during DPCR5 negotiations, and accepted by Ofgem, are of equal relevance to Transmission Operators it would be logical for Ofgem to consider any proposals put forward by companies.

Question 4: Do you agree with our proposed "next steps"?

We would welcome further discussion with Ofgem on the appropriate allowances for controllable opex before initial proposals are published in August this year.

CHAPTER Five : Update on Approach to Financial Issues

Question 1: We are seeking stakeholders' views on whether the available evidence supports leaving the assumed cost of equity unchanged for the TPCR4 rollover year.

Our evidence, as set out below, supports leaving the cost of equity unchanged and certainly should not be reduced from the current level of 7.0%

Updating the same methodology which was applied at TPCR4 produces a range for the cost of equity of 6.5% to 7.7%. The midpoint of this range is 7.1% which is 10bps above the cost of equity allowed for TPCR4

		TPCR4 2006		**NERA Update 2011**	
a	Geometric mean	5.5%	5.5%	5.3%	5.3%
b	Volatility	na	20%	na	22%
c	Variance (=b^2)	na	4.0%	na	4.8%
d	1/2 Variance (=c/2)	1.0%	2.0%	1.2%	2.4%
e	**Implied arithmetic mean (=a+d)**	**6.5%**	**7.5%**	**6.5%**	**7.7%**
f	**Midpoint of range**	**7.0%**		**7.1%**	

Source: NERA calculations

Question 2: We are seeking stakeholders' views on whether there is sufficient evidence to support updating the assumed cost of debt for the TPCR4 rollover year.

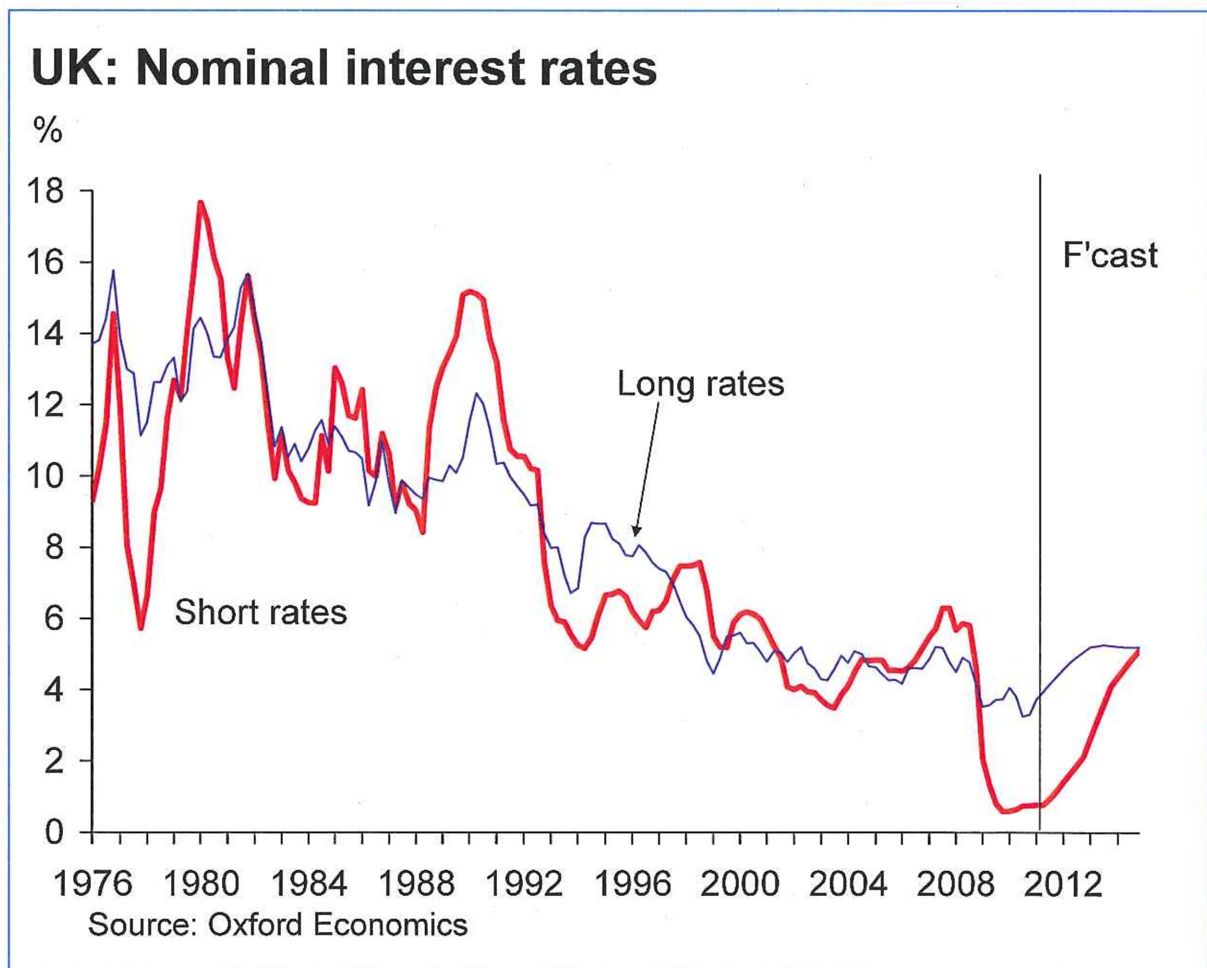
We demonstrate below that, overall, there is insufficient evidence to reduce the cost of debt.

Risk free rate

The Smithers report states:

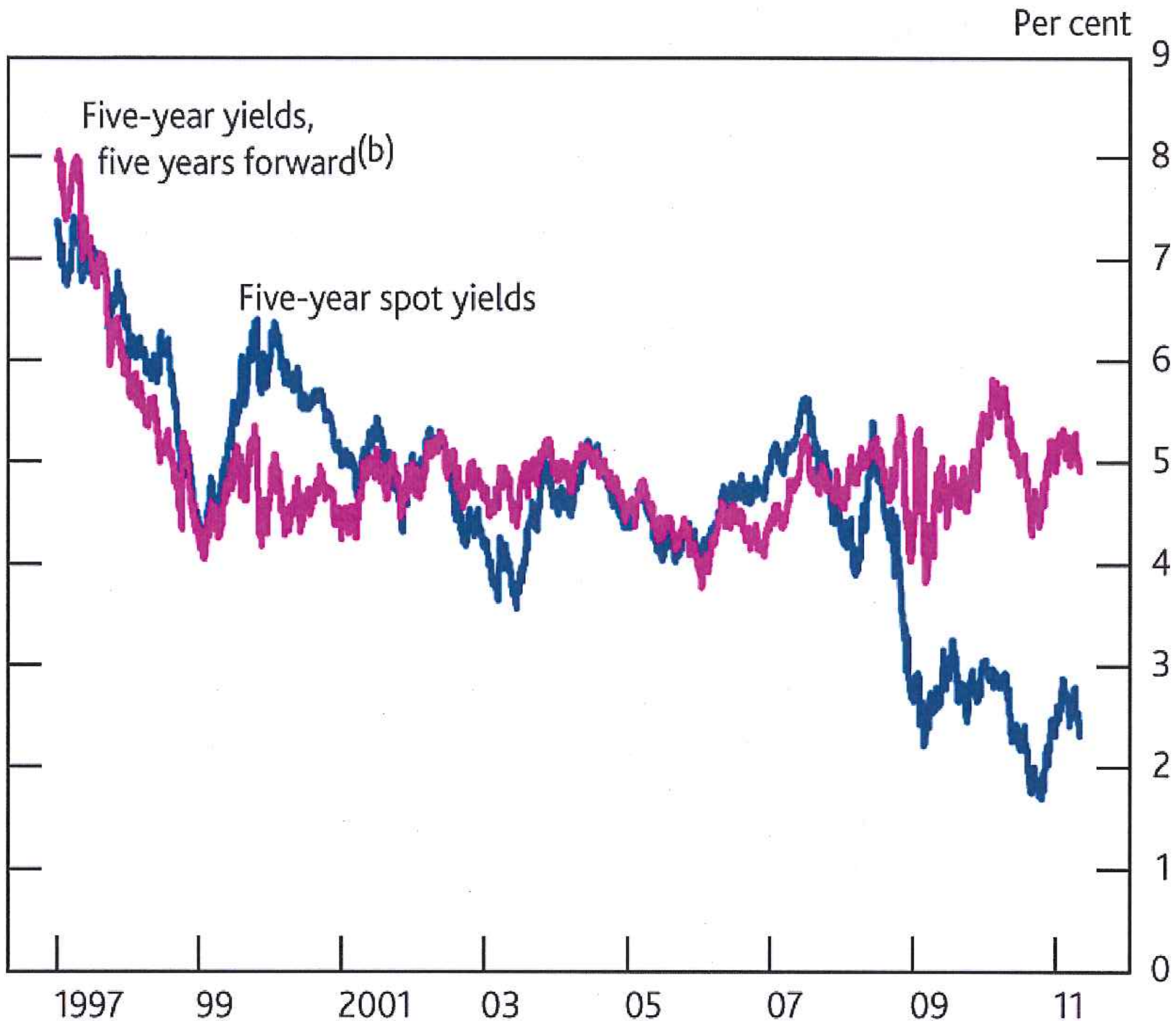
> *"In the absence of any evidence of a significant term premium, probably the best current market-based estimate of the forward-looking real interest rate is the nominal yield on medium dated bonds, less the Bank of England's inflation target of 2%: thus a figure of around 2 to $2^{1}/_{2}$%, based on the most recent figures." (Page 44)*

Nominal interest rates are forecast to increase by 2012/13, as quantitative easing is reversed. Oxford Economics are forecasting long term interest rates of 4.84% for 2012 and 5.23% for 2013. Over the same period, inflation is forecast to fall back to the 2% target. This results in a sharp increase in real interest rates.



At the time the Smithers report was written spot yields were in line with forward yields. However, the recent decline in spot yields has not been matched by a corresponding fall in forward yields, which are now above those prevailing when TPCR4 was determined.

Chart 1.4 UK five-year nominal spot gilt yields and five-year yields, five years forward[(a)]



Sources: Bloomberg and Bank calculations.

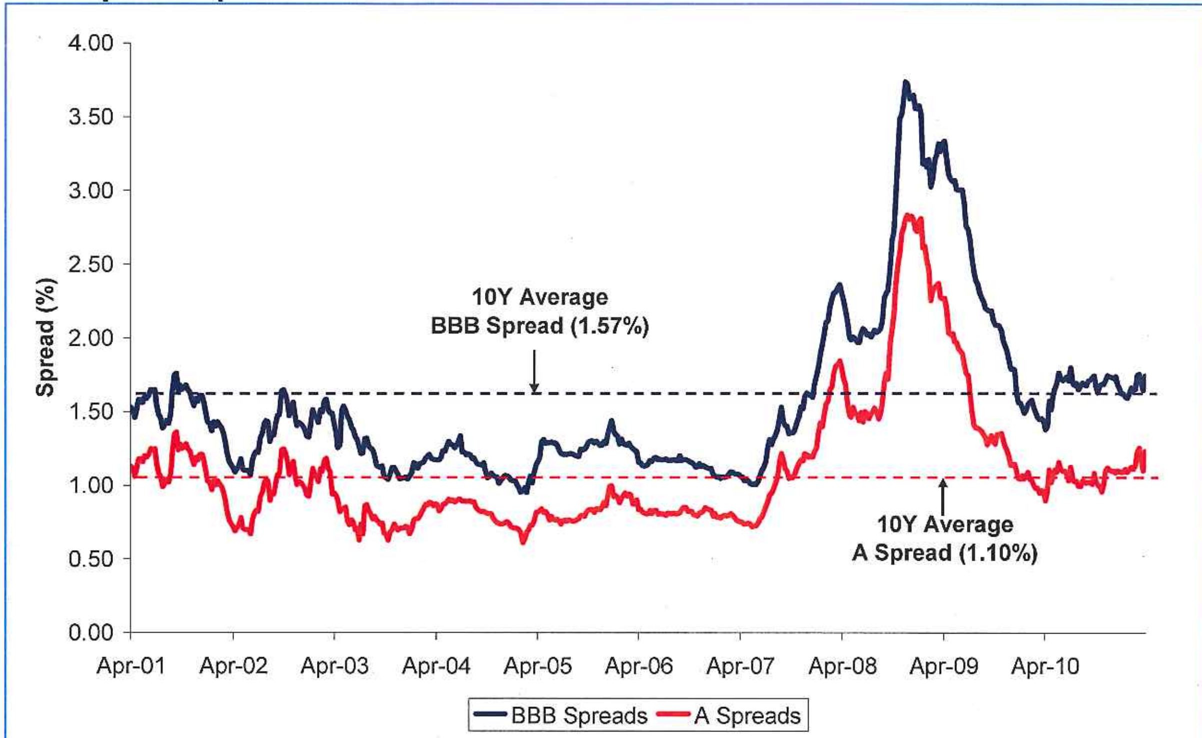
(a) Zero-coupon yield.
(b) Derived from the Bank's government liability curves.

Debt premium

At TPCR4, Ofgem set the debt premium of 1.25% at the mid-point of the long term average of spreads of A and BBB rated debt. The 10 year average spreads for A and BBB rated debt are 110bps and 157bps, respectively. Following Ofgem's approach at TPCR4, the debt premium is 134bps (calculated s the mid-point of the range of 110 to 157bps).

Overall, we do not accept that there is sufficient evidence to reduce the cost of debt for the TPCR4 rollover year.

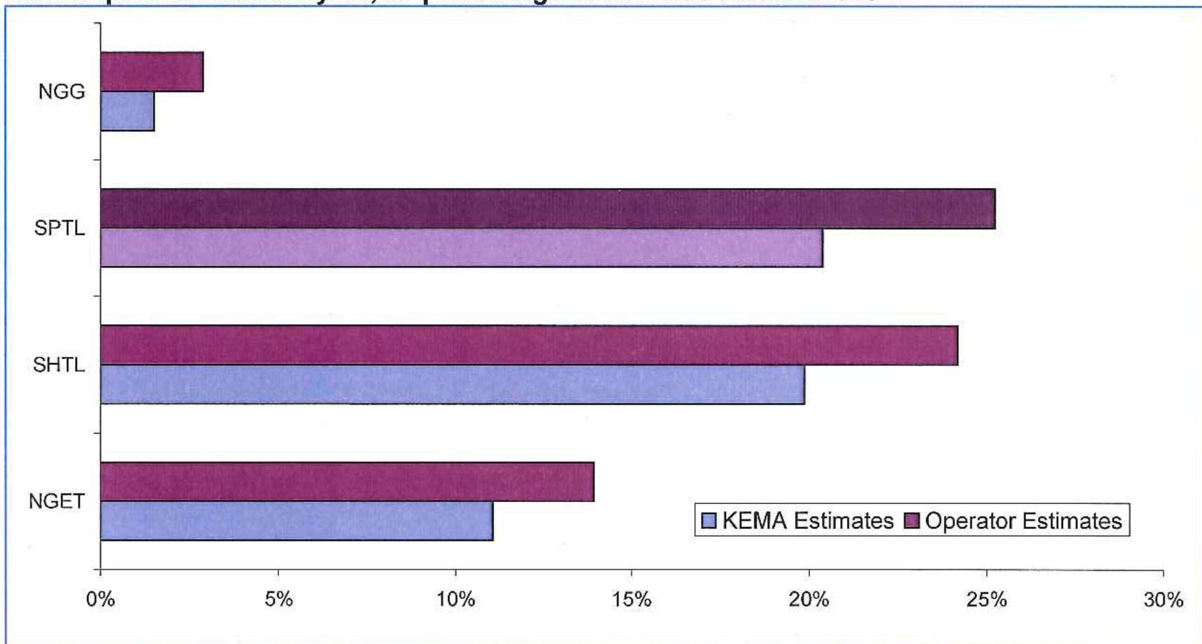
UK corporate spreads



Question 3: We are seeking stakeholders' views on whether we should review SHETL's notional gearing for the TPCR4 rollover year.

It is widely recognised that a larger capital expenditure programme (relative to RAV) will increase risk. We therefore support the case for use of lower notional gearing for both of the Scottish TOs, whose capex for the rollover year is a substantially larger proportion of the current RAV than for National Grid.

Base capex for Rollover year, as percentage of RAV at 31 March 2010



Operational leverage may be expressed as the ratio of fixed costs to total costs. Therefore, taking capital expenditure (capex) as a fixed cost, the impact of the capex to RAB ratio on operational gearing becomes more apparent.

The capex to RAB ratio is indicative of the extent to which operating income fluctuates with changes in revenues. Operating leverage thus amplifies the effects of the wider business cycle or macroeconomic environment on a firm's profits—and hence the sensitivity of firms' returns to market returns (or beta). To the extent that capital and operating expenditure is fixed over the control period, the expenditure to RAB ratio indicates the degree of operational leverage. Higher capex to RAB ratios result in greater operational leverage and thus higher business risk.

To offset this higher business risk for Scottish TOs, Ofgem should lower the notional gearing to offset the higher beta. In our view, it would be inequitable to review only SHETL's gearing.