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Regulation & Commercial

Gareth Walsh
Ofgem (Smarter Grids and Governance Team)
9 Millbank
London
SW1P 3GE

Your ref

Our Ref

Date
12 September 2011

Contact / Extension
Scott Mathieson
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Dear Gareth,

Consultation on TPCR Rollover Initial Proposals

Thank you for the opportunity to comment on Ofgem's consultation on TPCR4 Rollover initial Proposals. This response is written from SP Transmission Ltd (SPT), which as the regulated Transmission Owner (TO), owns and maintains the electricity transmission network in the south of Scotland.

I can confirm that this response is not confidential and can be published on the Ofgem website. In the supporting annex we have set out our responses where relevant to your specific questions. Our main points are:

WACC

We do not believe that the proposed reduction in the vanilla WACC and the allowed return sends the correct signal to investors at this stage, especially at a time when risk appetite is well below "normal" and, consequently, the price of risk has risen. The allowed return for TPCR4 was set at a time when both the price of risk was significantly cheaper than it currently is and risk was lower. Therefore, there is no basis to reduce the allowed return for the Rollover year.

Equity Issuance

We were disappointed by Ofgem's comments regarding the claw back of allowed equity issuance costs during TPCR4. In the interests of connected customers SPT has not and will not collect the equity issuance costs. As such, the claw back value shown in the Initial Proposals should be removed. This is a matter that could have easily been checked with the SPT Revenue Reporting team.

SP Transmission Ltd, Registered Office: 1 Atlantic Quay, Glasgow, G2 8SP Registered in Scotland No. 189126 Vat No. GB 659 3720 08
SP Manweb plc, Registered Office: 3 Prenton Way, Prenton, CH43 3ET Registered in England and Wales No. 2366937 Vat No. GB659 3720 08
SP Distribution Ltd, Registered Office: 1 Atlantic Quay, Glasgow, G2 8SP Registered in Scotland No. 189125 Vat No. GB 659 3720 08

Capital Investment – Difference between the Rollover and RIIO T1 Forecast for 2012/13

The proposed funding for the TPCR4 Rollover year of 2012/13 set out in Ofgem's Initial Proposals at £170m (2009/10 prices), is higher than our July RIIO T1 Business Plan forecast of £137m. The fundamental reason for this change is delays in the consenting process for various projects.

The starting point for the development of our RIIO-T1 plan was actually to use our TPCR4 Rollover forecast and then update this forecast based on (i) actual progress in the interim period (October 2010 to June 2011) and (ii) changes in assumptions on when projects might proceed based on new information received. Our experience is that delivery plans become much more robust as projects move towards the end of the consenting process hence we believe that our latest forecast for 2012/13 is more accurate.

This also highlights the challenge we face in accommodating the uncertainty surrounding renewable developers' desired connection dates set against the reality of the planning process which they need to negotiate. This is something that we have been engaging renewables stakeholders on. It highlights the benefits of the volume driver and revenue trigger approach, which we proposed previously and within our RIIO T1 submission, which is calibrated to make sure the TO receives funding at the right time, and also ensures that connected customers are protected.

As part of our review process for the Rollover, we will be providing Ofgem with a detailed reconciliation between our Rollover forecast of October 2010 and our RIIO T1 business plan submission of July 2011.

Load Investment – Ofgem's Approach

We understand why Ofgem and their consultants wish to reduce the load related allowance for certain specific schemes but Ofgem must bear in mind that they are removing capital expenditure for contracted connection projects placing a commercial risk on companies.

It is important that Ofgem understands the contractual environment between the TO and the SO as set out in the SO-TO Code, and reflected in the TO Construction Agreements (TOCAs) in place between SPT and NGET. Irrespective of the likelihood of a renewable generation project going ahead, we must comply with the terms and milestones of every TOCA i.e. we cannot discriminate by focussing our effort on those projects more likely to proceed.

Incentives – SF6 Leakage rate

Philosophically we support a scheme with an improvement rate target but whilst we acknowledge the increase Ofgem has made in the SF6 target leakage rate from 1.17% to 1.34%, this target is still far too low, given that the majority of our existing equipment has a design leakage rate of 3%. Prior to the publication of the Initial Proposals we had stated that we require a minimum level of 1.5%. However our historical performance over the past four years, due to equipment performance issues, has been 2.02%. We would suggest, that our target should be similar or higher than National Grid's, as we have very similar asset types and age profiles, and NGET's target leakage rate at 1.75% is more aligned to our current performance.

Should you have any further comments please to do not hesitate to contact myself, Alan Michie on 0141 614 1958 or Stuart Reid on 0141 614 1959.

Yours sincerely

Scott Mathieson
Regulation & Commercial Director

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Annex

Section 2 Summary of Proposed Capex and Opex Allowances

Question 1: Comment on proposed operating cost allowances for the transmission companies.

Ofgem have reduced our operating cost allowance by 10.1% from £19.9m to £17.9m to cover the deduction of related party margins (in line with Ofgem policy), an efficiency factor of 1.5% per annum, and disallowed an increase in tower painting costs.

Ofgem's proposed allowance, whilst accommodating our Non Operational Capex forecast in full, falls someway short of our expectations for ongoing controllable opex. Since our Rollover submission in October last year we have submitted our RIIO-T1 submission which contains additional data in respect of 2010/11 and an updated forecast for 2012/13. We will be providing Ofgem shortly with reconciliation between the two forecasts, in which we will make our detailed arguments for increased funding.

Question 2: Comment on proposed capital expenditure allowances for the transmission companies

We support the principle of proportionality to the one-year extension to the existing transmission price control (TPCR4), covering the period 2012/13.

Our starting point for the development of our RIIO-T1 plan was to use our TPCR4 Rollover forecast and then update this forecast based on (i) actual progress in the interim period (October 2010 to June 2011) and (ii) changes in assumptions on when projects might proceed based on new information received. Our experience is that delivery plans become much more robust as projects move towards the end of the consenting process hence we believe that our latest forecast for 2012/13 achievable.

As part of our review process for the Rollover, we will be providing Ofgem with a detailed reconciliation of changes between our Rollover forecast of October 2010 and our RIIO T1 business plan submission of July 2011.

We would make the following detailed comments:

1. Whilst it is recognised that there are adjustments to historic capex within the RRP for capitalisation of related party margins, depreciation and excess capitalisation, we believe that it is misleading to allocate this to the Other TO category (Appendix 4, Table 25 & Note 4). This is demonstrated by the summary of allowances included in the main body of the Initial Proposals (Chapter 2, Table 7, P57) where the non-load related allowance is quoted as £65.4m (please refer also to point 4 below).

2. We are not able to validate Ofgem's £9.8m adjustment in 2012/13.

3. We have been consistent in the treatment of related party margins for the TPCR4 Rollover and RIIO-T1 plan. Therefore, for capex comparison purposes (plan-on-plan and year-on-year) we will continue to include within our proposals.

4. In Appendix 4, Table 25 "Small Windfarm Connections" relates to SQSS Compliant & <100MW windfarms. In the period, Afton and Brockloch Rig wind farms satisfy these criteria. This is load-related investment. Similar to point 1, this is misrepresented in Chapter 2, Table 7, which portrays a non-load related investment clause whilst also including this load related investment.

5. We note the reversal of KEMA adjustments associated with "Infrastructure-Entry Triggered" costs for Revenue Driver qualifying projects (T4.24 of Rollover FBPQ refers). This relates to projects – Newfield, Waterhead Moor, Whiteside Hill and Andershaw – and translates to an adjustment of £7m increase on KEMA's view. It should be noted, however, that this adjustment creates a logical inconsistency for, "Generation Connection – Sole-use" investment. The aforementioned (RD qualifying) projects have (GC-S/u) investment disallowed as a result of the original KEMA probabilistic approach. Furthermore, the KEMA view is not reflected in a resultant change in contributions. A logical treatment, predicated on Ofgem's adjustment, would re-introduce £5.2m to GC – Sole-use (i.e. was £13.6m; becomes £18.8m). This, along with the remaining changes advised by KEMA, would infer a consequent reduction in Contributions of £0.5m (i.e. was £8.9m; becomes £8.4m).

6. The impact of project delays to key load projects is fully documented in the recently submitted RIIO-T1 plan. It translates to a gross load related expenditure in 2012/13 of £67m (Best View) compared to £113.6m (Ofgem Initial Proposals). This is exemplified by the following major projects (2012/13 expenditure):-

   (i) SW Scotland Collector: FBPQ = £30m; Initial Proposals £22m; RIIO-T1 plan = £8m and attributable to delays in obtaining consents.

   (ii) Moffat Collector: FBPQ = £22m; Initial Proposals £22m; RIIO-T1 plan = £14m and attributable to delays in obtaining consents for Moffat-Earlshaugh overhead line which KEMA assessed during the TPCR4 Rollover consultation process.

Load Investment

We are concerned at the approach taken by Ofgem and their consultants to reduce our load related allowance by reducing capital expenditure associated with low probability schemes. Ofgem must bear in mind that capex associated with low probability projects is for contracted connection projects.

In practice, consent delays on various projects that have come forward in the period since our business plan submission last October means that our current load related funding requirement for 2012/13, as set out in our RIIO T1 business plan submission, is less than Ofgem's proposed load allowance. Hence unless Ofgem decided to apply this same approach for the Rollover year in the Final Proposals, this approach need not be an issue. The approach does highlight the need to ensure that in addition to a baseline ex ante allowance the TO can make use of volume drivers and revenue triggers to ensure funding is available for contracted projects, as required.

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Non-Load Investment
Our non-load related investment plans have been developed utilising current Asset Risk Management policies and procedures, which reflect the nationally agreed Network Output Measures methodology. It uses extensive current asset condition information and is put in context against our asset replacement age based modelling. The combination of condition and modelling data, along with site criticality, has ensured plans reflect the key investment priorities.

We are continuing to address the delivery challenges in our non-load related investment programme. As such, and reflecting progress over the last year, we have updated our current best view of a realistic and deliverable programme in the RIIO-T1 plan submission of 28th July 2011. It closely aligns with the views put forward by Ofgem's consultants and translates to £73m in 2012/13, directly comparable to a KEMA view of £70m. Furthermore, our current proposal lies within the KEMA range £67m - £76m as documented in their April 2011 report.

Our revised plans continue our emphasis of delivery during TPCR4 where we will be on course to:

- Complete our plans to replace the unreliable gas compression cables
- Deliver 17 transformers, 3 more than the original TPCR4 allowance
- Deliver 26 Circuit breakers, 2 more than the original TPCR4 allowance
- Deliver a significant volume of overhead lines work, with the acceleration of the major XF route re-conductoring now being completed fully in a one year outage season, completing in early 2013 rather than a 2 year outage programme.

As discussed at the visits earlier this year our focus during TPCR4 has been on

- Substation related assets – switchgear (incl. disconnectors / CTs /VTs etc), transformer, protection & civil infrastructure asset modernisation. This has been prioritised based on Condition/Health Indices/System importance & operational adequacy.
- Completion of gas-compression cable replacement by end-TPCR4, further improving system reliability for customers. Minimising spend in RIIO due to satisfactory performance of remainder.
- Refurbishment of OHL network, mainly insulator/ fittings replacement, continue but slower than originally planned. Conductor replacement programme has been reduced to accommodate substation related investment and coordinate with strategic reinforcement plans. Investment forecast to increase from 2011/12 onwards.

This has all been against a background where project cost increases have been typically 30% above allowance.

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Section 3 Incentives and Uncertainty Mechanisms

Question 6: Comment on initial proposals for the structure of the incentives and uncertainty mechanisms for the rollover year for the electricity and gas transmission licensees.

We consider that the structure of incentive schemes for the Rollover year is proportionate. For electricity transmission, we note that for the Rollover year it is proposed that:

- Only Critical National Infrastructure costs will be logged up,
- Costs passed through during TPCR4 will continue to be passed through,
- The existing electricity revenue driver mechanism will continue however no new revenue driver mechanisms to be introduced,
- The revenue adjustment via the capex incentive will take place on a provisional basis with the incentive rate remaining unaltered at ±25%,
- The reliability incentive will continue and the incentive parameters will remain unchanged, and
- The SF6 incentive structure and reward will remain unchanged. We have included specific comments on the SF6 incentive in question 8 below.

Question 8: Comment on proposed revised SF6 leakage targets for the rollover year.

SPT continues to support the concept and implementation of the SF6 incentive mechanism. Whilst we acknowledge the increase in the SF6 target leakage rate from 1.17% to 1.34%, this target is still too low given that the majority of our existing equipment has a design leakage rate of 3%. Prior to the publication of the Initial Proposals we had stated that we require a minimum level of 1.5%. However our historical performance over the past four years, due to equipment performance issues, has been 2.02%. We would suggest, that our target should be similar or higher than National Grid's, as we have very similar asset types and age profiles, and NGET's target leakage rate at 1.75% is more aligned to our current performance.

We have commented that despite the introduction of new SF6 assets across the network, there would be no significant improvement in SF6 leakage rates until we removed the worst offenders from our network. Much of our legacy SF6 assets were installed with design leakage rates of 3%, which over time, and despite periodic maintenance, have deteriorated. Further, the option to urgently replace SF6 switchgear assets can be problematic given that one has to consider investment priorities (in terms of network safety and reliability), and also minimise constraint costs.

Ofgem has stated that the target should "be reduced in line with electricity TOs performance to date". The table below sets out our actual leakage versus the current TPCR4 targets from 2007/08 and, although only four years of data is available, the table shows that our actual leakage averages 2.02% over the past 4 years. This is supported by our experience to date mid-way through this current year 2011/12. As already commented, we also note that NGET has very similar asset types and age profiles to SPT yet has a target leakage rate significantly above SPT's at 1.75%.

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Table of Actual SF6 Leakage

	2007/08	2008/09	2009/10	2010/11	2011/12
Actual mass of SF6 leaked (kg)	930	774	731	780	
Inventory mass of SF6 (kg)	38,750	39,079	40,449	41,270	
Actual Leakage Rate of SF6 (%)	2.40%	1.98%	1.81%	1.89%	
Current Target Leakage Rate (%)	***-***	***2.00%***	***1.83%***	***1.67%***	***1.50%***

If the principle is to set a target which is to reduce in line with performance to date then we believe a fairer target for the Rollover year should be between 1.8% and 2%.

Question 9: Comment on proposal to apply the capex incentive adjustment over a number of years to protect users of the transmission system from fluctuating charges.

We recognise the attractiveness, in general, to stakeholders of avoiding fluctuations in transmission charges. However, we consider it is more effective to avoid fluctuating charges by smoothing allowed revenue overall. It may well be less effective to attempt to spread the adjustments arising from individual incentives, as there are other major components of allowed revenue which also change from year to year.

Nevertheless, if the capex incentive is to remain effective, it must be ensured that the revenue adjustments over time fully reflect the opportunity cost of capital which the licensee's owners face, when making their group-wide investment decisions.

Question 10: Comment on approach to maintain the existing revenue drivers for the electricity transmission licensees into the rollover year.

We agree with the approach to continue with the existing electricity revenue driver mechanism and not introduce any new revenue driver mechanisms for the Rollover year.

Question 11: Comment on proposed timeline for the application of the rollover capex incentive and reconciliation of the provisional TPCR4 capex incentive.

We agree that it is pragmatic to calculate the capex incentive for the rollover year in 2013 once the full dataset is available leading to a revenue adjustment taking place on 1 April 2014.

Section 4 Financial Proposals

Question 12: Do you think the proposed allowed return is appropriate to a one year rollover?

We are opposed to the proposed reduction in the vanilla WACC.

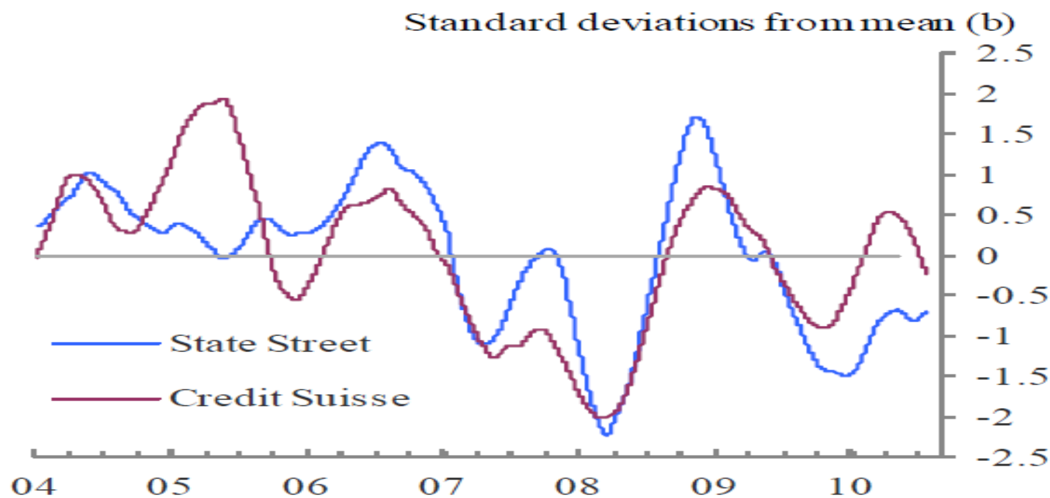
Reducing the allowed return at this stage sends the wrong signal to investors, especially at a time when risk appetite is well below "normal" and, consequently, the price of risk has risen. As Andrew Haldane (Executive Director of the Bank of England for Financial Stability and Member of the Financial Policy Committee) very recently said[1]:

> "During 2008, risk appetite dramatically tailed-off. At its low-point in early 2009, it was more than two standard deviations below normal. Since then it has ebbed (risk off) and flowed (risk on). Today, it is around one standard deviation below normal and falling. Risk is "off"."

And

> "For much of this century, risk was cheap. Today it is expensive."

Risk appetite [(a)]



Sources: Bloomberg, Credit Suisse and Bank calculations.
(a) Indices are adjusted so that positive numbers indicate increased risk-taking and negative numbers indicate reduced risk-taking.
(b) 90-day moving average of standard deviations from mean. Mean and standard deviation calculated from 28 July 2004.

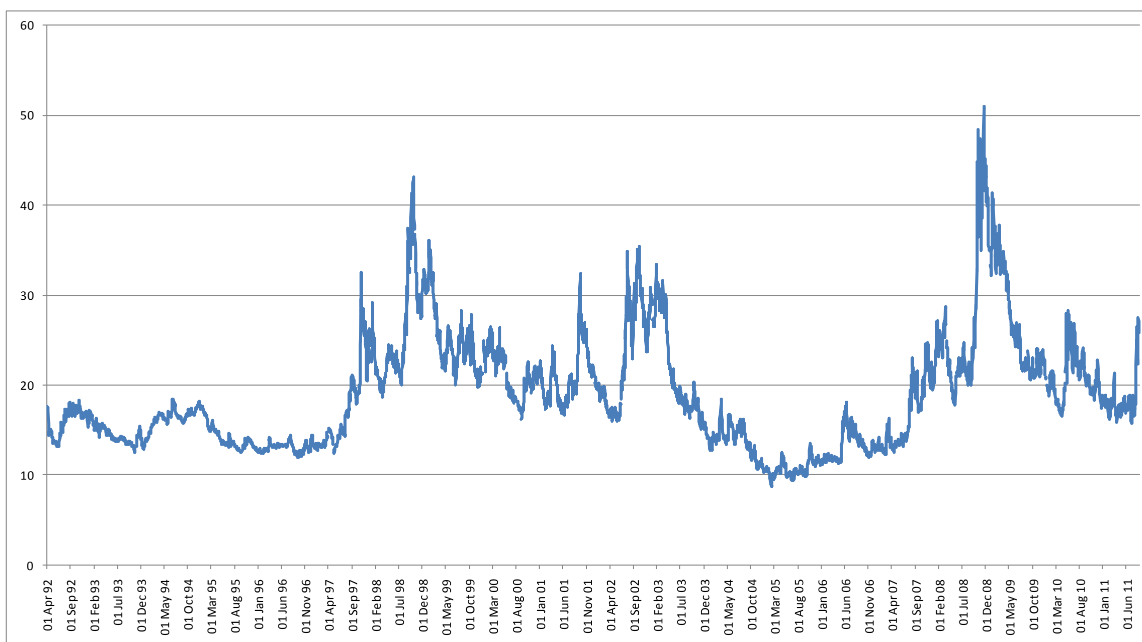
[1] Haldane, Andrew G, "Risk off", Speech, 18 August 2011

At the same time that risk is "off", risk has increased, again. The option implied volatility for the FTSE 100 in six months' time has increased sharply again during August 2011, reflecting further deterioration in conditions in the financial markets. It would be grossly over-optimistic to assume that, contrary to the observations from the financial markets and the concerns of the financial authorities, somehow, conditions will have returned to normal by the start of the roll-over year.

As Paul Fisher, Executive Director of the Bank of England for Markets, Member of the Monetary Policy Committee and Financial Policy Committee has observed[2]:

> "Tail events seem to happen far more often than people assume".

Implied Volatility for FTSE 100 in six months' time



Source: Bank of England

In addition, data from option prices continue to show that investors perceive greater downside risk in equity prices.

The allowed return for TPCR4 was set at a time when both the price of risk was significantly cheaper than it currently is and risk was lower. Therefore, there is no basis to reduce the allowed return for the rollover year.

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[2] Fisher, Paul "Tail risks and contract design from a financial stability perspective", Speech, 1 September 2011

Cost of Debt

By focusing on the apparent reduction in the risk free rate, Ofgem have understated the cost of debt. The observed reduction in gilt yields has not been matched by a corresponding reduction in the yields on corporate bonds. Gilt yields have been suppressed by the policy of quantitative easing and downgrades in the credit ratings of sovereign debt in some other countries. It is increasingly difficult to use these indicators as reliable measures of the underlying risk free rate.
Furthermore, the spread on UK corporate bonds has widened. For example, the yield on sterling corporate bonds (with maturities of 10 years plus) on 1 September 2006 was 5.43%, whereas by 1 September 2011 it had risen to 5.86%.

Yields on A and BBB Corporate bonds since the Smithers' Report

Source: Markit Benchmark Indices

Gearing

It is not sufficient to assess financeability over the single year of the roll-over as credit rating agencies typically assess financial ratios over three to five years and take into account future trends in these ratios. SPT's business plan submission for RIIO-T1 is based on 50% notional gearing, so as to ensure comfortable investment grade financial ratios, especially for PMICR. Therefore, we do not believe that 60% gearing is sustainable.

Furthermore, SPT's gearing (net debt / RAV) at 31 March 2011 was 41%, which is well below Ofgem's proposed notional gearing of 60% for the roll-over year. We note that the Competition Commission generally uses actual or projected gearing, in preference to an assumed notional gearing.

In addition, allowing for TIRG and TII expenditure, SPT's investment programme, relative to RAV is twice that of NGET's (30% and 15%, respectively). We note that NGET is, itself, seeking a reduction in notional gearing to 55% for RIIO-T1. In view of SPT's relatively larger capex programme, the notional gearing assumed for SPT should be below that for NGET.

Equity Issuance

We were disappointed by Ofgem's comments regarding the claw back of allowed equity issuance costs during TPCR4. In the interests of connected customers SPT has not and will not collect the equity issuance costs. As such, the claw back value shown in the Initial Proposals should be removed. This is a matter that could have easily been checked with the SPT Revenue Reporting team.

Question 13: Do you agree with the adoption of the new pensions methodology for the rollover?

We agree that the adoption of the new pension's methodology for the Rollover is appropriate.