

Hannah Nixon
The Office of Gas and Electricity
Markets
9 Millbank
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Your ref

Our Ref
RIIO T1

Date
22 November 2011

Contact / Extension
Alan Michie
0141 614 1958

Dear Hannah,

Initial assessment of RIIO-T1 business plans and proportionate treatment

I am responding on behalf of SP Transmission Limited ("SPT") on your Initial Assessment of the RIIO T1 business plans published on 24 October.

We are pleased to be retained in the fast-track process. As you know, we are currently working with your RIIO T1 team to address the points raised in your Assessment on our business plan. Substantial progress has been made and we are pleased to see that many issues / queries have now been resolved.

Financial Submission

Although you confirmed in your Initial assessment that we had produced a good level of detail in our plan, you did raise concerns surrounding our financial submission. We have now provided your team with considerable supporting information on our submission to the extent that we believe that we have justified our position that our plan delivers borderline investment grade, at the level indicated by the Ofgem team as being a fair deal for consumers. We examine this on a holistic basis, as was envisaged in your RIIO T1 strategy, taking into account the risks we face given the scale and complexity of the programme we must deliver. Our financial work is married to the engineering challenge directly as the two clearly interact.

We remain concerned about the impact of some of the policy changes that RIIO T1 proposes. For example, the proposed cost of debt indexation leaves us exposed to significant interest rate risk, when interest rates rise, at some point in the future. Our plan must be calibrated to address this concern from a financeability perspective.

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The level of revenues modelled in our financial submission is the minimum needed to ensure that cash flows deliver the target mid BBB/A credit ratios post risk. This means that this revenue must be guaranteed through the Licence mechanism regardless of whether the revenues associated with our forecast expenditures are derived from base revenues or uncertainty mechanisms.

Delivery Model

We recently met with your team to set out how we intend to deliver our full work programme, in terms of both scale and cost-efficiency. We explained how our project delivery organisation fits in to our overall organisational structure and the key differences between the traditional EPC turnkey approach and our delivery model, including how our relationship works at an operating and commercial level. We also provided evidence of real cost savings using recent projects as examples. Our feedback is that Ofgem's queries around delivery and cost-efficiency have now been resolved.

This delivery approach has the advantage in obtaining the benefits of improved leverage via global purchasing, and through disaggregating project elements such that technical and commercial risks are managed and controlled in house. The expertise available within our delivery organisation, and the associated delivery methodology, means that project work elements can be disaggregated and supply of materials and services re-aggregated under appropriate procurement strategies. This opens up new delivery options and introduces fresh and competitive capacity from the supply chain. However, this approach does increase risk primarily due to the increased number of contracts and contractual interfaces.

Uncertainty Mechanisms

Our business plan sought to take full account of Ofgem's March 2011 strategy decisions for RIIO-T1 and build on the existing uncertainty mechanisms which have been applied during TPCR4, which are well understood. It would be counter-productive to attempt to develop novel and untried mechanisms, where existing mechanisms have been demonstrated to work satisfactorily. We are especially mindful of the risk of unintended consequences arising from regulatory mechanisms, which can distort incentives and divert resources from activities and outputs, which customers and other stakeholders consider to be more desirable.

Hence we propose a limited number of uncertainty mechanisms for RIIO-T1, which will mitigate the impact of developments outside of SPT's control. These are summarised in the following table:

Uncertainty	Mechanism
Economy wide inflation	RPI indexation of revenue
Licence fee and business rates	Pass through
Cost of debt	Indexation
Pension deficit	Repair
Tax rates and legislation	Tax trigger
Protection of national infrastructure	Re-openers
Connections expenditure	Volume driver
Wider reinforcement works	Trigger mechanism
Non-load works	Volume Driver
Financial Distress	Disapplication of the price control

Our plan makes use of revenue drivers to protect customers from being charged for investment which may be delayed, for example, if the planning process delays consents, or may not turn out to be required during RIIO-T1, such as particular reinforcement projects, if use of the network develops differently from currently anticipated. By avoiding the inclusion of such projects in the baseline, we have sought to protect customers from unnecessary charges. We will shortly provide Ofgem with more information on our proposed uncertainty mechanisms.

In summary, I would conclude by reaffirming the very good progress that has been made so far. From our perspective the key area that must be resolved is the financial package that supports delivery of this critical national infrastructure programme against a context of significant risk.

Please be assured that we are committed to continuing to work with you and our external stakeholders to resolve any remaining gaps.

If you have any queries please do not hesitate to contact me or Scott Mathieson on 0141 614 1612 .

Yours sincerely,



Alan Michie
RIIO T1 Project Manager