



**SP Distribution and SP Manweb (SP Energy Networks)**

**Response to Electricity Distribution Price Control Review**

**Initial Proposals August 2009**

(Reference 92/09, 93/09, 94/09, 94a/09, 95/09)

**Executive Summary**

**14<sup>th</sup> September 2009**

## **Introduction and Overview**

Scottish Power Energy Networks (SPEN) welcomes the opportunity to respond to Ofgem's Electricity Price Control Review (DR5), Initial Proposals consultation documents.

Whilst we are encouraged that the proposals recognise the need for substantial investment in the industry to manage the UK's ageing Distribution infrastructure and deliver European and UK energy policy, we are disappointed by the significant number of areas that remain outstanding, or are a long way from complete, notably the cost of capital, pensions and operating cost allowances.

From our perspective there are a number of key issues that must be addressed and upon which the success of this price review will rest; these can be summarised as follows:

**Cost of capital:** We see no case to reduce the current cost of capital and every case to increase the rate of return given current market conditions, international competition for investors' funds and the scale of the investment to be undertaken.

This has been underlined by the economic data we have submitted to date, by an Investor Survey undertaken by the ENA on behalf of the DNOs and Ofgem, and most tangibly by reading across from the recent negative impact on the share price of those Water companies that remain listed in the UK, following Ofwat's initial proposals for price controls in 2010-2015 determination.

We are concerned that Ofgem did not provide their view on the range for the WACC and instead relied on an extremely wide and therefore unhelpful range provided by their consultant. This means that unlike in the Water sector, or the case of previous electricity reviews, we are unable to effectively gauge investors' reaction and sentiment to the initial proposals.

We would highlight also that there are major shortcomings in PWC's report as it fails to take account of the current market conditions against which companies are seeking to borrow or attract record levels of investment.

**Operating Costs:** We are concerned about the robustness of work in this area and have found approximately £100m worth of errors or omissions relating to the treatment of vehicle & transport costs, fault costs and SP Manweb costs that we expect to be addressed. We expect that these will need to be corrected and included in our allowances going forward.

The last two years of Ofgem cost reports have indicated that SP Distribution (SPD) appears to be the second most efficient DNO in terms of operating costs and yet the initial proposals indicate an allowance that will be substantially below SPD's actual DPCR4 costs, despite upward cost pressures due to the ageing asset base, a rising risk profile, and the need for a significant increase in maintenance, and activity to support investment.

We have been disappointed by the lack of a clear audit trail and coherent model structure that would provide companies with the transparency to complete a validation of Ofgem's work, together with a challenge of any apparent discrepancies and correction of any errors. As a result our review has therefore required, so far as is possible, a forensic investigation of the data that Ofgem's team has provided.

Our review of this area of work has highlighted two key concerns. Firstly, we do not accept that the Ofgem models are fit for purpose; the work is not statistically robust e.g. half of the regressions for disaggregated costs fail the model specification tests, which indicates that one or more explanatory variables have been omitted and/or the functional form is inappropriate. Of the remaining four regressions, two have an R-squared of 0.4 or less. Secondly, we have found approximately £100m worth of errors or omissions relating to the treatment of vehicle & transport costs, fault costs and SP Manweb costs. We expect that these will need to be corrected and included in our allowances going forward.

We also note that at the moment Ofgem have not taken account of any increased costs associated with the introduction of new obligations such as the provision of greater information to Renewable Generators or complex connections reporting.

**Capital Expenditure Allowances:** In contrast to operational costs the modelling in this area has been relatively well communicated and transparent.

However, there are still a few areas that give us concern, in particular in relation to condition-based asset replacement. We continue to work with your teams on these areas. We are also conscious that at the time of writing, Ofgem had not reviewed approximately £150m of capital expenditure and we await news on these items in your September update paper.

**Inflation/Real Price Effects:** We anticipate that Revenues will be affected by a negative retail price index (RPI) in the first year of the price control. However, the stark reality is that utilities continue to be adversely impacted by prices for labour, materials and contractors over and above RPI. This will adversely impact companies' ability to finance their activities.

It is unreasonable to expect the DNOs to be able to keep costs at or below inflation in this environment. In particular, we believe that Ofgem has understated the labour cost pressures that DNOs, their contractors and manufacturers will face during the next six years by failing to recognise any differential wage inflation for skilled infrastructure specialists and by assuming that average earnings return to an inexplicably low rate of growth when the recovery from the current period of recession is completed. It is also important to note the position on these matters of CEPA, upon whose work Ofgem relied, has changed dramatically. We would refer Ofgem to

their latest report published this month that we understand aligns with First Economics position.

The risk companies face in this area will be further compounded by the proposals that they are being asked to sign up to in terms of output measures. We support output measures and have supported Ofgem throughout this process in this area but if companies are asked to bear the risk of both outputs and price effects this dramatically increases risk and reduces expected returns. Nor do we accept that this issue is covered by the Information Quality Incentive mechanism given the scale of risk that shareholders would still bear for commodity prices that are largely outwith their control.

We have previously proposed a form of indexation related to a basket of indicators for RPEs, which would operate beyond an appropriate threshold. We envisaged such a mechanism would operate symmetrically and protect both consumers and companies. Alternatively an "iDOK" type mechanism such as is in place for the Water companies could provide a solution.

<p><b>Incentives:</b> the potential to earn returns beyond the headline cost of capital should not be seen as a substitute for getting the headline cost of capital correct in the first place. To be clear, the headline rate must match what an investor expects for a company that meets its targets and commitments to customers while maintaining its credit rating and <u>before</u> taking any out-performance into account.</p>
---

Ofgem has highlighted the unintended consequences (whether positive or negative) on companies' results from incentive mechanisms during DPCR4. We support this area of work to understand better what potential impact could arise from incentive mechanisms. However, the potential to earn returns beyond the headline cost of capital should not be seen as a substitute for getting the headline cost of capital correct in the first place. To be clear, the headline rate must match what an investor expects for a company that meets its targets and commitments to customers while maintaining its credit rating and before taking any out-performance into account. If any further proof were needed, our unsatisfactory experience in DPCR4 demonstrates that investors cannot rely on incentives giving an uplift to the cost of capital.

We believe that the price review has in fact increased risk overall given the increasing level of intrusion and complexity of incentive mechanisms. For every example of perceived de-risking, a new risk has appeared, for example the stringent performance criteria for New Connections.

Regarding risk, we disagree with Ofgem's general approach to caps and collars across all incentive mechanisms since it appears to expose companies to significant cash-flow volatility in any given year since any cap or collar is effectively applied at the end of the five-year period through a "true-up" mechanism. We believe this approach should be revised to follow the precedent set by the current quality of service mechanism.

**Losses:** We remain concerned that the Losses mechanism is still not achieving its core objective but we do recognise that Ofgem are trying to move the debate forward. In determining whether proposals are acceptable to us, we will carefully consider the balance of risk posed by the level of the targets, the method of reporting and the cap and collar mechanisms.

We must also make it absolutely clear to Ofgem that a significant penalty arising from the flawed DR4 Losses roll over mechanism may ultimately jeopardise our Board's ability to accept the new price control package. This is particularly a risk as the final year's performance disproportionately magnifies the financial impact of Settlements volatility in the final years of this price control through the roller mechanism. Our first position remains that the roller should be switched off however, noting Ofgem's opposition, we have also proposed adopting Ofgem's "buy out" mechanism and recommended that this is based on a final year estimate for losses that applies an average of the first four years of the current price control period.

We believe that the Low Carbon Fund could present an exciting opportunity to take forward key flagship projects, if the mechanism is applied in a balanced and objective way.

On the package of incentives overall, we believe that the proposals will increase the complexity of the overall package and in particular that its transposition into detailed Licence Condition modifications will be challenging. It will be vital that work on the detailed modifications is appropriately resourced.

<p><b>Pensions:</b> In light of Ofgem's review of this area, recent evidence such as the Government Actuary's Department report and the reaction of key stakeholders, it is vital that Ofgem now confirm the continuation of the existing pension principles, including the funding of full pensions liabilities</p>
--

There is now strong, independent evidence of the fact that the stewardship of pension schemes in the Electricity sector is both effective and efficient as evidenced by the recent Government Actuary's Department report. It is also important to note that the Electricity Industry is unique in comparison to other regulated infrastructure businesses in incorporating the "Protected Persons' status" for pre-vesting employees as embedded in the Electricity Act 1989.

At a company level, ScottishPower's schemes are already well run and we continue to have a strong efficiency incentive given the significant proportion of our schemes that are not covered by the Distribution Price Control Review.

The existing pensions principles incorporate tests of efficiency and spread the recovery of any deficits over a 10-year period allowing Ofgem to take account of future scheme valuations and market changes and make any appropriate adjustments on a present value basis. Companies signed up to these principles, which in terms of their amortisation period are relatively onerous, in the belief that they would be applied consistently going forward.

Any significant change in this area will undermine regulatory consistency and increase perceived risk.

This is also a heavily regulated sector governed by the Pensions Regulator and Pensions Acts, together with the strict professional rules surrounding the independence and conduct of scheme actuaries.

**Other financial issues:** In these difficult economic times we seek Ofgem's assurance that in completing their financial modelling exercise that they will be applying a set of criteria that matches confident or safe achievement of an A- credit rating for an efficient company.

In these difficult economic times we seek Ofgem's assurance that in completing their financial modelling exercise that they will be applying a set of criteria that matches confident or safe achievement of an A- credit rating for an efficient company. Further, that in running the financial models to analyse this the impacts of deflation, RPEs and pension funding will be given strong consideration against companies' ability to achieve that rating. Ofgem should also be mindful that the transition to using opening statutory capital allowance pools might also require revenue adjustments in some instances to avoid an effective double count of capital allowances.

In light of Ofgem's own recent work on financial war games and companies' financial health, this exercise will be of key importance

### **In Summary**

We have set out above the key areas that will affect our Board's consideration of whether or not to accept the price control package for DPCR5. In light of those comments we would urge Ofgem to:

- *Publish an initial view on WACC at the earliest opportunity, recognising the international pressures on financing large investment programmes.*
- *Provide transparency on operating costs to enable validation, challenge and to make the corrections we have highlighted to arrive at an acceptable level for allowances in the Final Proposals.*
- *Confirm that the existing pension principles will be applied to DPC5 as soon as possible*

In the attached documents we pick up these items in more detail, providing a rationale for our position together with our proposed solutions and we provide responses to Ofgem's detailed questions and appendices.

Cost of Capital	Section 2.3
Operating Costs and Capital Allowances	Section 4
Inflation / RPEs	Section 2.2
Incentives / RORE calibration	Section 2.4 & 3
Pensions	Separate response to Pension consultation