NEW DOCUMENT

RIIO T1 Business Plan Update

Business Support Services

December 2011

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BUSINESS SUPPORT SERVICES

Our business support services are the indirect costs encompassing the provision of Information Systems & Telecommunications support; Property Management; HR; Finance, Audit & Regulation; Insurance; Procurement; and CEO/Corporate functions.

The cost of providing these services for our Transmission business will amount to approximately £11m per annum on average during RIIO-T1.

Cost Drivers and basis of allocation

We state in our business plan that business support costs are largely unaffected by movements in our capital investment program. These costs are generally by their nature fairly remote from direct activities of any sort, capex or opex, and are more typically a reflection of the size and scale of an organisation.

Our IT & telecoms costs are influenced primarily by the number of users within SP Energy Networks allocated to Transmission. HR costs are again a reflection of the size of the workforce they service in SPEN and allocated to Transmission. Finance costs are driven in part by the number of transactions processed in SPEN (e.g. Payroll, Purchase Ledger, Sales Ledger, Payment processing etc), and also by the number of staff preparing management accounts, statutory accounts. The two Distribution businesses pick up the lion's share of costs based on volume, Transmission takes up a small allocation. Regulation costs are mostly headcount related and our fte's are dictated by the size of the regulatory caseload.

Justification and Efficiency

In considering whether the overall level of business support costs for SPTL can be justified, we can use Ofgem's final proposals for DPCR5 as a good benchmark as it covers the very same activities.

The DPCR5 post IQI allowance awarded by Ofgem for business support costs for our two Distribution businesses amounts to around £53m per annum (09/10 prices).This provides a reasonable context in which to assess our Transmission forecasts for RIIO-T1.

Our Detailed Data Tables forecast would indicate that SPTL accounts for around 17% of the total costs of the regulated businesses (ie when we include SP Distribution and SP Manweb). This would indicate that our forecast of around £11m per annum for Transmission costs is robust.

Forecasts of business support costs ought to be more predictable than other parts of the plan insofar as they are more generally fixed in nature (almost 60% of indirect costs relate to pay).

Given that, the major risk considerations that could lead to a radical change to any companies' forecasts would probably be connected to a change in control ie a market transaction of some sort. It is only events of this type that lead to significant changes in corporate/ IT/ shared services costs etc. Otherwise, our objective remains to focus on incremental efficiency improvements to offset cost pressures.

Interaction with Outputs

The levels of business support costs are generally unrelated to the level of outputs. If we mean by outputs, network outputs, then if we take our non-load capital investment programme for example, the replacement profile in our plan is a reflection of the health index of our asset base and the criticality of the assets.

Outputs are therefore not really dependant at all on the level of HR resources, IT or Finance/Regulation; activities which although in themselves are key to the effective operation of any major organisation are not directly associated with direct activities or outputs.

Organisational Model

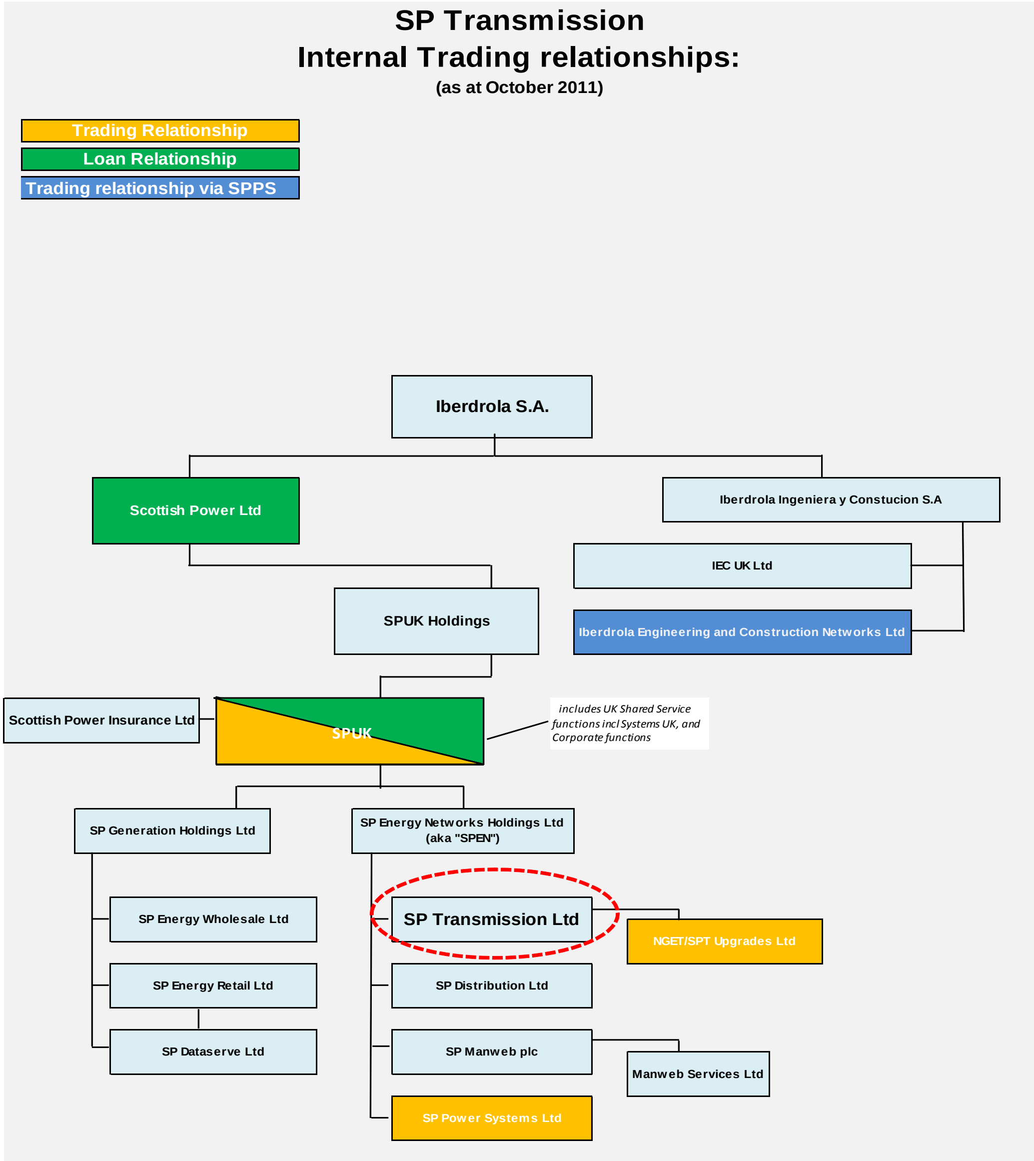
The business support services described above are, for the most part, provided through our UK Corporate Shared Services model.

Under this arrangement group services are charged to the respective business units in the UK group by direct allocation, where this is possible, or by apportionment using an agreed basket of indicators[1]. The charging methodology is reviewed annually by Ofgem as part of the cross-subsidy agreed-upon-procedure undertaken by our external auditors.

IEC business support costs are embedded within the business support costs of our submission. They amount to £0.9m pa (09/10) over the life of the plan.

A simplified extract of our organisational model below shows the relationships between each of the businesses:-

[1] The basket of indicators is established from each division's percentage of the group total for the following categories: Turnover; Operating Profit; Net Assets; Employee Numbers. The methodology has not changed from TPCR4.



Our overall strategy is described in more detail below

1. IT & TELECOMMUNICATIONS STRATEGY

A Multi-Layered Strategic Approach
Iberdrola operate a global IT model with local implementation by Group companies. The overarching aims of the IT model are Service, Efficiency and Integration with the following specific objectives:-

- **Global Solutions** – to develop and deploy solutions globally that promote integration of the group and provide "best in class" capability through integration of people and teams globally;
- **Global Consolidation** – to unify core applications that such that they are shared globally with a view to reducing complexity and Total Cost Of Ownership;
- **Exploit Global Scale** - to leverage and exploit the size and geographical reach of Iberdrola when technologies are being procured to unify to a small number of strategic suppliers – hardware, software and services;
- **Sharing Of Best Practice Globally** – to promote the sharing of knowledge to promote best practice technologies, processes and methods to optimize IT processes. The objective being to be efficient and to provide service excellence to IT "customers".

These objectives require the need for common, globally aligned, IT disciplines across:-

- **Governance** – common governance across all IT activities;
- **Service Delivery** – centralised service delivery function to manage the day to day operations and fulfilment of end user requests;
- **Project Delivery** – a common approach to project management underpinned by strong centralised programme management office;
- **Architecture** – a centralised architecture function that is able to promote "best practice"; consolidated IT solutions with a focus on optimizing infrastructure investments and services.

The IT strategy cascades down from a holistic global strategy to strategies specific to each global line of business. Energy Networks in the UK is therefore driven by the Global Regulated Business IT Strategy. This strategy has been developed under an initiative known as the Networks Business Applications Road Map (NBAR) with input from the regulated businesses in Spain, UK and USA. The NBAR initiative spans the following five areas:

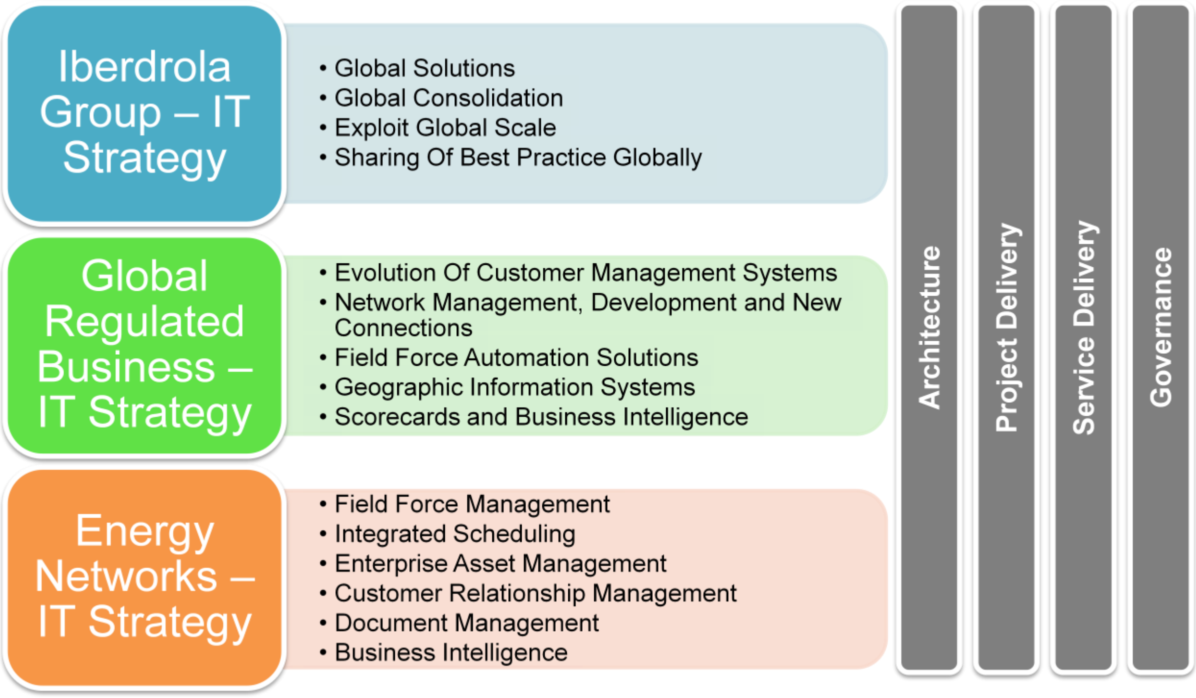
- Evolution Of Customer Management Systems;
- Network Management, Development and New Connections;
- Field Force Automation Solutions;
- Geographic Information Systems;
- Scorecards and Business Intelligence.

Energy Networks – UK Regulated Business – IT Strategy

Energy Networks have developed an IT strategy that aligns to the Global Energy Networks IT Strategy but is dedicated to meeting local requirements. The Energy Networks IT Road Map consists of six strategic workstreams:-

- Field Force Management
- Integrated Scheduling
- Enterprise Asset Management
- Customer Relationship Management
- Document Management
- Business Intelligence

The overall strategic approach is summarised in the diagram below:-



Implementation of Strategy in the UK

Systems UK is the team responsible for the delivery of IT services to all UK business units, including Energy Networks, with the exception of the development and operations of the SCADA platform and associated critical operational infrastructure, all which relate to the operation of the network and are provided by the Real Time Systems (RTS) group.

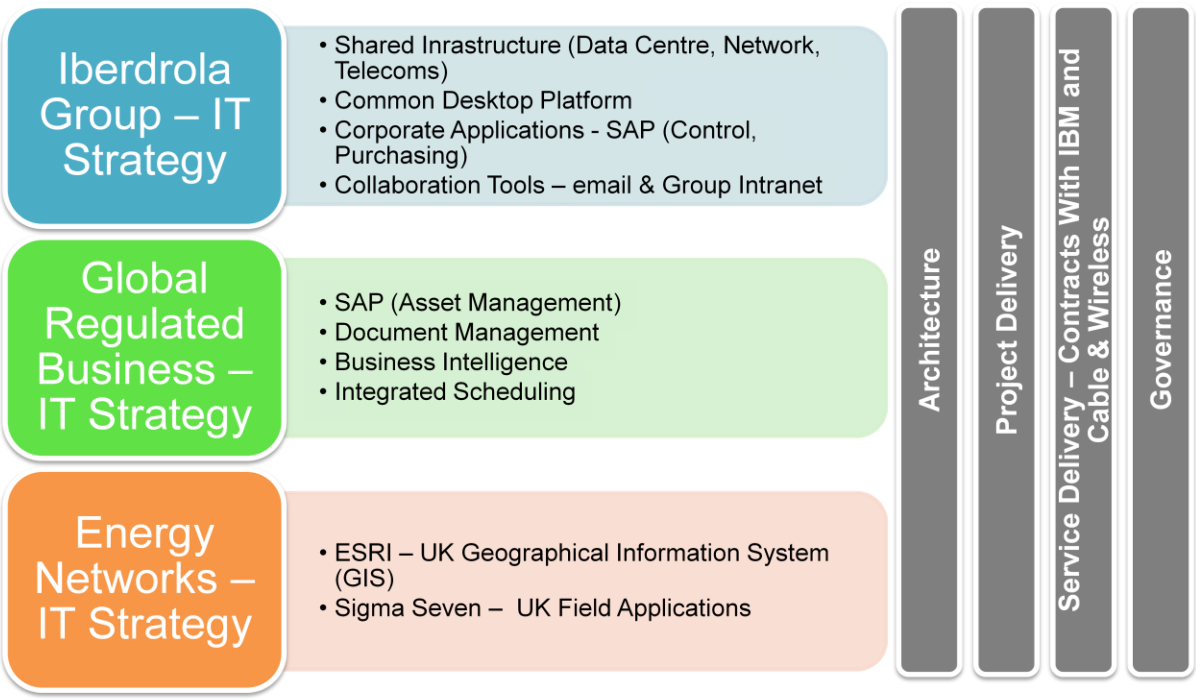
The UK Systems team provide commercial & planning, operations and technical architecture expertise as well as specific project delivery resource. Project delivery is managed and governed by the Systems UK team, with the actual development and integration of the solutions being provided by external parties. All development work is put to competitive tender where possible to ensure that the best solution is provided at the most competitive cost

In terms of the existing UK IT estate, the major contracts for service delivery are competitively tendered by Iberdrola with the objective of leveraging the size and scale of the Iberdrola group to deliver solutions and services that are shared globally. Therefore in many cases Energy Networks consumes a portion of either a UK wide or global service, application or contract. The most significant examples of this approach are:

- SAP – Energy Networks uses the global SAP platform for financial and asset management.
- Telecoms – a UK wide contract with Cable & Wireless for the provision and support of telecoms infrastructure for data and voice. This contract will expire 31 December 201
- Service Delivery – a UK wide contract with IBM for the provision of IT infrastructure (data storage, servers, database) and business application support This contract will expire 31 March 2021.

The costs of providing these services are re-charged to the individual business units within the group, based on a formula typically pro-rated based on the number of users that use that consume the service.

In terms of the major contracts in place to support the strategy, these are mapped out onto the model below:-



Benchmarking and Market Testing

A benchmarking study conducted in 2009 for Ofgem by Mouchel, for the DPCR5 price review, assessed the DNO's IT operating costs, systems and practices.

ScottishPower emerged as one of the leading companies out of that report. Quoting from Mouchel's final report;

On costs – "...*several operating companies clearly demonstrate cost efficiency using our IT benchmarking key performance indicators, these are CE, EDFE, SP, SSE and WPD"*

On evaluating key policies and practices against best practice.- *documentation on policies and practices was provided by all operating companies. Some organisations demonstrated higher levels of efficacy than others, these are CE, CN, EDFE, SP and WPD"*

On evaluating current and planned applications systems in terms of functionality and cost effectiveness – "... *the level of future capex planning for DPCR5 is somewhat patchy. A number of organisations provided evidence of detailed plans, projects and budgets – these are CE, CN, SP and WPD."*

In general they found that *"..the overall standards of IT diligence are higher than we find in most other industries."*

Key Investments (Non-Operational Capex) during RIIO-T1

Energy Networks shares IT applications where possible for the management of both its distribution and transmission assets. On this basis a core set of IT platforms has been established to support the major functional requirements for the business. As mentioned above the investments over the RIIO-T1 period will continue to develop and integrate these platforms in the following workstreams:

a. Field Force Management - this programme will deliver an integrated suite of applications designed for ease of use by field staff incorporating workflow, geographical, maintenance, inspection and data capture tools;
b. Integrated Scheduling - this programme will develop a fully integrated scheduling capability that enables resource forecasting and capacity planning coupled with real-time scheduling of the field work force;
c. Enterprise Asset Management - this programme will develop integrated processes and systems that manage the asset lifecycle from concept, design, construction through operations and maintenance to decommissioning;
d. Customer Relationship Management - this programme will develop a customer services platform that enables all interactions with customers to be coordinated and optimised.
e. Document Management - this programme will establish a common document management process and repository for the entire business enabling documents to be managed throughout their lifecycle. A key focus will be the linking of documents to the relevant assets.
f. Business Intelligence - the programme will establish a central reporting and analysis tool for the business. A key focus will be the production of regulatory reports directly from core applications.

Basis of Cost Allocation of costs to businesses

Contracts and costs which are directly associated with business specific applications are apportioned directly to each business. This covers any 3rd Party maintenance and support of applications, the dedicated internal resources providing IT services and project delivery and application development.

Contracts and costs associated with applications shared between Scottish Power businesses are based on apportionment model based on the number of users.

Contracts and costs associated with shared infrastructure with Scottish Power businesses are based on apportionment model based on a mixture of capacity utilised and number of users.

The UK wide contract with Cable & Wireless for the provision and support of telecoms infrastructure is based on percentage of line and service usage.

2. PROPERTY MANAGEMENT STRATEGY

Background
Management of the UK property portfolio is the responsibility of the Estates department, part of the Corporate Shared Services structure in SPUK, with key strategic decisions being referred to Iberdrola for approval.

The strategic focus of the management of the UK property portfolio over the last few years has been to maximise the use of existing sites and dispose of any sites that have been underutilised or no longer fit for purpose due to location, age or condition. This strategy has been used successfully, for example in the relocation from the Portobello Office in Edinburgh and the establishment of smaller offices within nearby existing grid substation sites, and in the recent establishment of the new depot at Cambuslang, Glasgow which allowed the closure of the Motherwell office and reduction in the St Vincent Crescent site operations.

This approach of reviewing the location, age and condition of the existing portfolio against the business requirements is continuing with the development of an overall "Property Strategy Paper".

Overall Strategy
ScottishPower, as part of the Iberdrola Group, has recently begun a review of its non-operational properties in the UK with specific focus on the properties within Central Scotland. A "Property Strategy Paper" has been approved by Iberdrola to allow further research into the consolidation of ScottishPower's property assets so that a number of sites can be brought together to deliver operational efficiencies and savings in overall property costs. The consolidation of property assets will also allow the introduction of the Iberdrola standards on office fit out and design and allow Iberdrola Group properties to have a similar look and feel.

The ScottishPower Group currently operates from a number of owned and leased properties predominately within the central belt of Scotland. A number of the owned properties now need capital investment as mechanical and electrical systems are reaching the end of their useful lives and are also in need of general cosmetic upgrades. In addition a number of the leased sites have leases expiring over the next 9 years.

Facilities Management
ScottishPower changed the way it contracted for Facilities Management[2] during 2010. The previous arrangements involved employing an umbrella service provider, [redacted], to coordinate all FM activities, either internally by their subcontractors or with strategic third parties.

A comprehensive review of that contract took place in 2009 which found a number of inefficiencies, in particular the duplication in management roles, both internally within the Scottish Power structure and the [redacted] supervising the sub-contractors.

[2] Managing the facilities within the estate includes building maintenance, security, cleaning & waste management, mail & reception, photocopy and other

Approval was given for a change to a multi-contract provision of services, with ScottishPower directly engaging with 3rd parties for FM services utilising the global reach of Iberdrola to tender widely and secure volume savings. We have engaged [redacted] to provide a front-end FM Helpdesk and resource management. They utilise the contracts put in place by ScottishPower for the following FM services:-

- Security - [redacted]
- Cleaning and Waste Management – [redacted]
- Catering, Vending & Hospitality – [redacted]
- Mail, Reception, Telephony – [redacted]
- Building Maintenance - [redacted]
- Other FM Contracts (MFD's, photocopy paper etc) – [redacted]

This change in approach has removed the management overhead and margin retained by the managed service provider as well as providing additional non-financial benefits, including streamlined customer interface (one helpdesk, one owner) and a much clearer understanding of roles and responsibilities.

In terms of measuring performance improvement, we have now adopted the key performance indicators used by Drivers Jonas in their efficiency assessment undertaken in 2009 for DPCR5.

In that assessment, although ScottishPower were found to have better than benchmark unit costs, there was scope for improvement in space utilisation.

SP Energy Networks context

SP Power Systems, as the principal affiliate and service provider to the three licenced businesses, operates from a number of sites across Scotland, North West England and North Wales with the majority of these sites being owned. At the present time there are no plans for any relocation from any of the existing offices or depots of Energy Networks with exception of the properties at New Alderston House, Bellshill and Glasgow Road, Falkirk. The current level of operating costs has been brought down to just over £9m per annum.

The future "Property Strategy" that has been approved for further development at Iberdrola Group level could have an impact on the sites at New Alderston House and Glasgow Road, Falkirk.

The property at New Alderston House, Bellshill is a standalone 3 storey office pavilion in Strathclyde Business Park extending to approx 3716sqm and accommodates 330 desks. The property is leased with an expiry date of 22nd August 2014. This property is included within the Property Strategy due to the lease expiry and the need for a decision to extend the lease or relocate to a new site. New Alderston House is the main office property for SP Energy Networks and accommodates the main Management, Regulation and Finance functions.

The property at Falkirk is shared with the SP Energy Retail business albeit both parts of the site are distinct and separated by security. The Energy Retail premises are ageing and are being considered for closure. The Energy Networks portion of the site is used for storage and is an overflow from the nearby Bonnybridge depot.

The strategic review is still in the early stages of development and will need further approval from the SP Business Boards, the ScottishPower UK plc Board and the Operating Committee of Iberdrola which, if received is not expected to be until mid 2012.

Transmission Context

SP Transmission Ltd incurs around £1m of the overall £9m annual cost of the SP Power Systems property portfolio, with the main Distribution companies incurring the majority of costs. The charge is a reflection of the number of staff within SP Power Systems working on transmission activities compared to Distribution ((currently around 224 staff out of a total of around 2,500 employees.

3. INSURANCE STRATEGY

Background
Scottish Power's corporate insurance function works with the business to ensure a thorough and consistent approach to mitigating an appropriate level of risk through transfer by insurance. A combination of the company's risk appetite, cost of insurance and statutory obligation dictates the level of insurance cover purchased.

Traditionally Scottish Power's strategy was to retain relatively low levels of risk while transferring the majority to one of our Captive insurance companies and insuring catastrophe levels of risk in the insurance markets. The Captives were developed following feasibility studies conducted at the time of their inception and issued policies covering our property, liability (employee and public) and motor risks. This enabled the company to smooth the level of risk on our balance sheet and provided an incentive for improving levels of risk management and loss prevention within the organisation.

Iberdrola's takeover of Scottish Power in 2007 created Europe's 3rd largest utility and a world leader in renewable energy. An organisation of that size requires a global approach to insurance and as a result of a diligence exercise on insurance arrangements, Scottish Power's insurance function was gradually combined with that of Iberdrola to provide economies of scale and consistent policy cover for its major exposures (property and general liability). Iberdrola's approach relied on higher retention levels within the businesses before transferring the remaining risk to the insurance markets.

The changes included:

- The adoption of Aon as IBE/SP's main current global insurance adviser (the last competitive tender for insurance broking services was carried out in 2011 and saw Aon retained in that position);
- The closure of Scottish Power's 2 captive insurers in favour of Iberdrola's Luxembourg-based reinsurance facility following a review of our risk financing arrangements by Aon;
- Global insurance policies incepted for Iberdorla's worldwide assets and liabilities.

Overall Strategy
Iberdrola have appointed specialist Global Insurance Brokers, Aon as their professional advisors and to place the required insurances in the market. The Corporate Insurance teams work closely with Aon (who service the Iberdrola Group companies from Bilbao and London) and the businesses to provide the necessary underwriting information for all classes of insurance, to allow insurers to evaluate the risk and price accordingly. In addition we also seek to retain the broadest scope of cover and where possible reduce exclusions and restrictions by promoting SP's investment and risk management philosophy to insurers.

The majority of insurance policies are global policies and are placed by the Iberdrola Insurance team in Bilbao. This allows us to achieve economies of scale in our premiums and Scottish Power is able to benefit from Iberdrola's purchasing power in the market. As a result we are confident we are driving the best value possible.

It is important that these global premiums are allocated effectively within the businesses as this can help to drive ownership within the company and a focus on improving the management of risk within the individual businesses. We also need to consider the regulatory nature of much of our Networks business and ensure that the allocation relates to the level of risk within that part of the organisation.

Local polices for Employer's Liability and Motor Third Party Liability insurance are placed in the UK to meet with the statutory requirements, and the insurance team work closely with Health & Safety, Occupational Health and Fleet Business to demonstrate our risk management philosophy and minimise increases in insurance premiums that may result from a hardening market. In addition to the Group and Local UK policies, there are two stand-alone policies which are purchased for SP Power Systems - Professional Indemnity Insurance and Contractors All Risks Insurance. These policies are required to meet with contractual requirements faced by the Distribution Connections business, and these policies are marketed by our brokers in order to achieve competitive premiums.

Outlook

The global insurance markets cycle between soft and hard phases, influenced by factors such as the global economy and the level of catastrophe losses experienced year on year (e.g. bad hurricane seasons, earthquakes etc). For example poor investment returns and high costs of losses impacting on reinsurance companies reduce the amount of capacity available in the market and leads to a rise in premium rates – which is known as a "hard market".

Insurance market conditions in the last 10 years have tended to be, and remain, soft, meaning an excess of providers and capacity and therefore an ability to negotiate relatively cheaper insurance costs. There are signs that, following a number of catastrophe events (Australian floods, New Zealand earthquake, Japanese tsunami) in the last year, that markets are showing initial signs of hardening – although this can take a number of years to manifest. Aon monitor this situation closely and part of their remit is to keep client's informed of trends and outlooks.

Hardening global property costs could have an impact on Iberdrola's insurance spend, particularly our global property exposure. Our exposure to these market prices can be controlled through use of the Iberdrola captive facility which would allow us to smooth prices and large increases from year to year. Control of forecasting these moves, through our year to year insurance budget and projections, lies with the Iberdrola insurance function in Bilbao.

Conclusions

Insurance costs are subject to a constantly evolving market cycle as well as the changing nature of any business. Premium rates have remained fairly low and stable for the last 7 or 8 years however there are initial indications that costs could start to rise given favourable conditions in coming years. Iberdrola and Scottish Power's insurance function tracks these movements to allow us to anticipate rises in premium rates and mitigate them through use of Iberdrola's re-insurance captive, retaining more risk within the business and improving our management of occurring losses.

Iberdrola retains the services of Aon, one of the largest risk and insurance advisers in the world. Aon's services assist us in assessing the risks that we are exposed to in all areas of the business and the most effective means of mitigation – through transfer or other control strategies.

Iberdrola's global scale and presence allows us to exploit economies of scale in both the placing of the company's insurance policies and our strategies for retaining risk within the business.