



RIIO T1 Business Plan Update

Delivery and Costs

December 2011

DELIVERY AND COSTS

Following our business plan in July, Ofgem requested some further clarification on the following topics. This paper summarises the face-to-face discussions and written responses we have provided to Ofgem.

- Market Testing
- Efficiency and Value for Money
- Iberdrola – IEC Model
- IEC Contract and Margins

1. MARKET TESTING

The Business Plan for RIIO-T1 submitted by SPTL includes an expenditure forecast of around £2.2bn (09/10) covering capital investment, network operating costs and indirect costs.

The plan shows that the vast majority of capital investment and network operating costs are provided by external 3rd parties, whilst the converse is true for indirect costs where the majority of costs relate to staff pay. Over 95% of Direct Capital Investment and 81% of network operating costs are outsourced, whereas over 56% of indirect costs relate to staff costs. The diagram also shows that IEC, SPTL's delivery partner, accounts for almost half of total indirect costs.

Capital Investment and Outsourcing

Details of our purchasing strategy and how we engage with the marketplace are described comprehensively in Section 7 of our Business Plan.

Market testing has been integral to our delivery approach for a very long time. All major Transmission schemes delivered by SPTL in the past have been competitively tendered on a EPC turnkey basis, whereby a principal contractor tenders to undertake all **E**ngineering, **P**rocurement and **C**onstruction activity. However, our experience has been that although each major project was competitively tendered, only four or five key contractors regularly participated.

As we describe in our plan our new delivery approach unbundles the EPC approach allowing us to engage directly with a much wider contractor/supplier base utilising a mix of scheduled rate framework contracts and individually tendered contracts for more expensive projects.

Our Procurement function has been very active implementing the new strategy and we can now confidently state that there is no aspect of transmission activity, which is outsourced, that has not been market tested in the last twelve months.

Operating Costs

Over 80% of our network operating costs are outsourced. Contracts are typically awarded under scheduled rate terms which have been competitively bid for and are typically two to three years in length. The most significant areas in terms of cost include:-

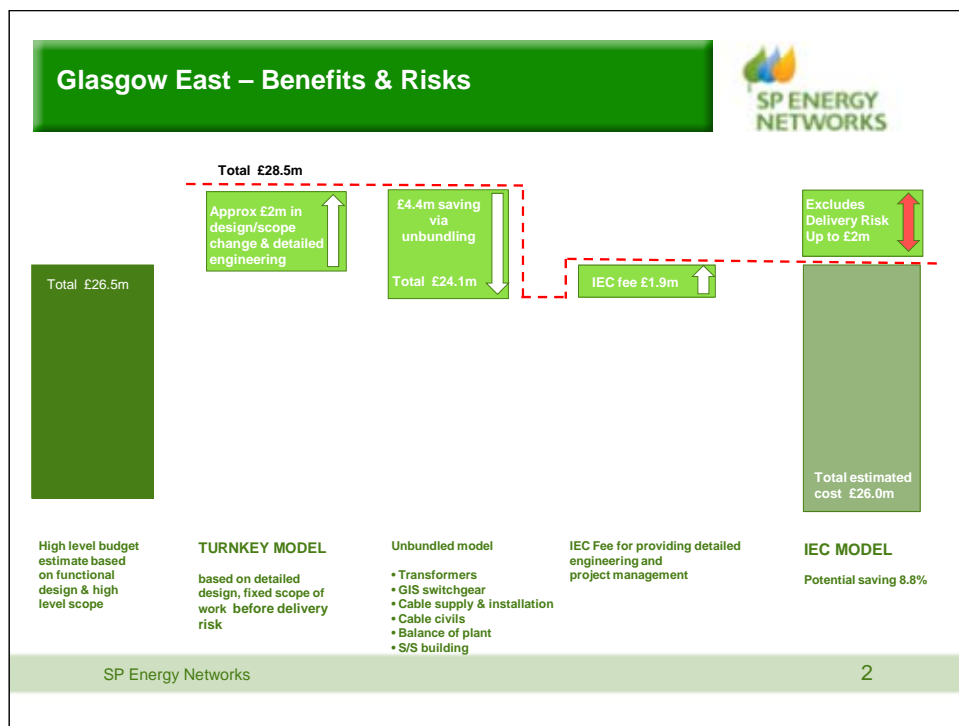
- Tower painting (new contract in place this year - 3 year duration)
- Helicopter OHL condition assessment and inspections (new contract in place this year - 1 year duration)
- Minor OHL refurbishment and faults (new contract last year – 3 year duration)
- Cable Maintenance Agreement ; maintenance of cables and faults (currently out to tender – will be a 3 year duration)
- Scaffolding for substation maintenance (currently out to tender – will be a 3 year duration)

2. MEASURING EFFICIENCY AND VALUE FOR MONEY

Our delivery strategy, which is described in detail in our business plan, provides the potential to deliver cost efficiencies compared to a traditional EPC contract approach. Since our July Business plan submission we have provided Ofgem with evidence of actual equipment purchases made under our new contract arrangements, which increase competition by being able to engage directly with a much wider supplier base.

Over time our delivery model has the potential we hope to yield efficiencies in engineering design, as IEC build up a portfolio of project designs that permit some standardisation. This is more difficult to achieve when contracts are delivered by different main contractors.

Turning to a real example that we have used previously with Ofgem to illustrate this point is the Glasgow East Project, a very high profile project given the Commonwealth Games dependency.



The diagram above illustrates our general point regarding the potential savings expected by unbundling the equipment and installation contracts (c£4.4m in this case), and the offsetting costs to IEC for providing detailed engineering design, cost estimate and project management.

Whilst our intention during RIIO-T1 is to ensure the cost/risk trade-off works to our advantage, we cannot be certain of the exact scale of the benefits at this early stage in the development of our new delivery strategy. Our early analysis indicated that overall cost

savings in the region of 5 – 8% might be achieved, and that is the general reduction we applied to our portfolio of “traditionally” costed projects.

Indirect Costs and the benchmarking of Pay

With nearly 60% of our indirect costs relating to pay, we invest considerable time and effort into understanding how our salary and benefits packages compare across the industry in order to inform our plans and future pay negotiations.

Scottish Power has several routes for benchmarking and ensuring efficiency of our pay / reward arrangements:-

- a) SP Reward Team
 - b) Benchmarking Groups
 - c) Benchmarking visits
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- a) We have a small team of reward experts who use a variety of independent sources to benchmark reward practice against other companies including Hay Group, Towers Watson, Mercer, CELRE, IDS and XpertHR.
 - b) We participate in an industry networking group comprising Reward professionals from Centrica, SSE, EDF, Eon, Npower and National Grid.
 - c) Energy Networks has also benchmarked with SSE and National Grid to compare reward practices.

In 2011 SP Energy Networks (SPEN) introduced the Hay Job Evaluation methodology across our business to ensure all roles are evaluated consistently. This has also allowed us to compare our pay practices with Hay industry market data (including SSE and National Grid).

We have engaged our trade unions in a significant project which seeks to modernise our collective reward arrangements, which cover c89% of SPEN Employees. This project requires negotiation with our Trade Unions and is aimed to –

- Improve compliance with equal pay and age legislation through removal of incremental progression arrangements
- Establish stronger more direct links to market data critical to ensure we can attract and retain employees
- Increase recognition of personal performance
- Deliver greater employee relations stability

Negotiations are ongoing with the aim of establishing the new arrangements with effect from 1st January 2012.

The remaining 11% of SPEN staff (covering middle/senior management roles) have personal contracts.

Personal contract pay arrangements are based on –

- Direct link to Hay market data
- Recognise personal performance

- Take into account business affordability with pay increases based on a performance related pay matrix

We will continue to benchmark with other companies to ensure that our pay arrangements compare favourably to other DNO's. Our strategy to introduce a modern reward framework will also ensure that our terms and conditions reflect market dynamics and support us to recruit and retain employees critical to support delivery of RIIO-T1.

IBERDROLA - IEC MODEL

Our business plan submission describes the reasons for changing from our traditional approach for delivering major construction projects via competitively tendered EPC contracts.

We believe that our new delivery methodology will secure several important strategic benefits:-

- Employing a deeper detailed engineering and project management model reduces the reliance on a limited turnkey/principal contractor market
- It allows second and third tier contractors to engage directly with SPTL, realising potential procurement efficiencies
- Reducing costs through the standardisation of designs will become more achievable using IEC than would have been the case using different turnkey contractors
- As we enter a period where significant programmes of work (load and non-load) have to be delivered and outage management is ever more critical our new model offers a significant improvement in control and co-ordination of delivery

A huge commitment to this new approach has already been demonstrated in terms of recruitment in IEC (Networks). From a base of 56 the team will have grown to 215 by December 2011 and to around 270 by December 2012. IEC's position as one of the world's leading energy engineering companies provides them with a large global reach in attracting resources.

IEC's core staffing levels are further complemented by a number of framework agreements which have been set up with multidiscipline engineering companies¹.

The new approach has opened up our supplier base considerably for equipment and installation offering wider choice and value. We are confident that the volumes set out in our business plan can be procured, since the capex increase is still considered modest in Iberdrola Group terms.

The one area of some uncertainty is overhead line installation where the number of UK market participants is quite limited. The increase in volumes that our plan demands places further pressure on resources and consequently prices. Our procurement organisation is actively pursuing a number of options to provide the level and quality of resources we require.

Over time our delivery model has the potential to yield efficiencies in engineering design as IEC become better placed to produce standard designs. This is more difficult to achieve when contracts are delivered by different main contractors.

The IEC model offers significant improvements in control by being better placed to co-ordinate and integrate the major programmes of work. This is essential when one considers the importance of effective outage planning.

¹ RIIO T1 Business Plan, Section 7 Delivering the Plan, Appendix 2 Page 13

3. IEC CONTRACT AND MARGINS

IEC provide detailed engineering and project management services only. They are not responsible for placement of contracts for equipment or installation; that still remains the responsibility of SPTL's principal service provider SP Power Systems (SPPS).

We are currently in contract negotiations with IEC to further enhance the incentive aspects of their existing contract with us for the next regulatory year (12/13), with the purpose of exposing IEC to an appropriate proportion of the risks and rewards that SPTL will face through the delivery of the outputs specified in the RIOT1 price control. The expectation is that the risk/reward component of the contract will be calibrated to reflect the typical range of risk that we would expect other contractors to accept in the market, with potential for IEC to experience a range of profit outcomes including a loss under certain scenarios arising from under delivery.

The contract includes provisions in the event of a change of control. For example in the unlikely event that Iberdrola divested IEC that would constitute a termination event which would activate the contract conditions for a controlled handover.