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Dear Cheryl

Transmission Access Review – Enhanced Transmission Investment Incentives: Initial Proposals - National Grid Response to Consultation Ref 135/09

National Grid welcomes Ofgem's continuing engagement in the development of regulatory arrangements for the establishment of the transmission capacity that may be needed to facilitate achieving the country's energy policy goals and targets.

The proposal to adopt "a simple, pragmatic funding approach at this stage" should maintain the option of meeting policy goals and targets by permitting progress on the new transmission capacity identified in ENSG's 2020 Vision.

However, the approach implies a delay to the implementation of a longer-term framework for delivering required network infrastructure and, in particular, incentives which encourage accurate anticipation of emerging needs rather than just responding to full user commitment (as is currently the case under TPCR4). While Ofgem's further review of the current reinforcement proposals with consultants should ensure only the most robust parts of current proposals are taken forward at this stage, the drip-feed funding and associated project specific micro-management increases the risk that network company decision making will be blunted in the key areas of further refining the reinforcement plans, assessing emerging information on need, managing interactions with other load-related activities, and establishing the required supply chain. On this basis, National Grid is disappointed that the work jointly progressed with Ofgem on revised investment incentives that are compatible with TPCR4 have been shelved.

In terms of the proposed interim incentives (prior to a possibly delayed TPCR5), we understand why Ofgem should retain the option to suspend funding if need for the works weakens or if insufficient progress is being made. However, we are concerned that an agreement to fund costs only to the end of TPCR4 will not recognise the need to make commitments on schemes, which due to their implementation times, will inevitably require spend to continue into TPCR5 (even if TPCR5 is delayed). Also, unless performance measures/milestones are carefully selected, the proposed incentives will expose transmission companies to penalties for short-term programme issues that would not, in general, jeopardise delivery of the longer-term outputs. On this basis, the decision points for halting works and the milestones/measures used to gauge progress need further work to ensure they do not themselves become barriers to progress.

Answers to the specific questions in the consultation are given below.

Yours sincerely

[By e-mail]

Lewis Dale
Regulatory Strategy Manager

Cc: Paul Whittaker
Mike Calviou

CHAPTER: Two

Question 1: Do respondents consider we have appropriately summarised the views of respondents to our September consultation?

We have assumed that Ofgem have captured the views of respondents appropriately.

Question 2: Do respondents have any comments on the initial findings of our consultants or views on the issues raised by the TOs?

On need case, the reinforcements proposed by network companies reflect judgements made during the ENSG process which collated industry views concerning the developments that might be appropriate to meet policy goals and targets. In reviewing these proposals, Ofgem and their consultants should not only consider whether any aspects of the network companies' understanding of need should be further updated (beyond that which has already taken place) but also whether any opportunities for better meeting policy goals exist. Given that Ofgem have stated funding will supersede TPCR4 revenue driver mechanisms, the review process should consider interactions with other load -related activities progressing under TPCR4.

In terms of planning criteria, the SQSS which forms a licence obligation on transmission companies is already the subject of a fundamental review. Given the issues already identified concerning the use of deterministic criteria to assess the network capacity needed when there are interactions between wind and conventional plant, we suggest emphasis should be placed on the cost-benefit assessments of the potential network reinforcements.

Given the views expressed in the TAR process concerning the development barriers that can be created if network companies only act in response to firm financial commitments from users, Ofgem and their consultants will need to look beyond current user commitment evidence and be mindful of emerging need together with policy guidance available from government.

CHAPTER: Three

Question 1: Do respondents have any comments on our proposed funding framework for additional investment within TPCR4?

Unlike the rejected option to delay all additional funding, the option selected by Ofgem does enable work to proceed towards establishing additional transmission capacity that may be needed to facilitate policy goals prior to the establishment of longer-term incentives in the next (potentially delayed) price control. However, it is regrettable that Ofgem does not consider the work undertaken on enhanced incentives during TAR is sufficient to establish a third option of putting in place enhanced long-term investment incentives at this time.

The proposed arrangement retains the option of suspending funding of reinforcements if emerging information suggests alternative plans may be more attractive. This provides an incentive on network companies to ensure that suitable decision points are established within the supply chain. Given this requirement, we appreciate Ofgem's approach of giving separate consideration to pre-construction and construction spends. We also appreciate the information given concerning the transition to funding arrangements under TPCR5 if it is agreed reinforcements should continue beyond TPCR4. However, it is the nature of transmission reinforcements that substantial commitments for construction must be made early in the project and the opportunity to avoid costs by suspending work at a later date can be very limited. This factor means that, unless decision points concerning hold or proceed are carefully chosen, there could be large risks on transmission companies which primarily result from the switchover from TPCR4 to TPCR5. On this basis, the nature and timing of decisions in which funding might be suspended needs to be clear on each project so supply chain mitigations of this risk can be developed.

Another potential downside of the proposed arrangements is the potential for transmission companies to increasingly rely on the drip feed of funding and other decisions by Ofgem as the key indicator of the efficiency of proposed works. This means Ofgem rather than network companies will become the de-facto investment decision maker and the duty to protect customers may lead to delay rather than an appropriate allocation of investment risks to network companies. While such delay should be contained to the 2 or 3 years prior to TPCR5, nevertheless this is important fraction of the time available for the industry to reach 2020 targets.

Moreover, the drip feed of funding reduces the ability of transmission companies plan and optimise the wider network development programme. As a minimum, the performance measures used to determine funding in TPCR4 should recognise that it may be beneficial to modify the delivery of items planned for TPCR4 in order to give better overall delivery (as will be visible subsequently in TPCR5).

Question 2: Do respondents have any views on the appropriate funding mechanism for provision of pre-construction funding?

In the absence of longer-term incentives, we agree that an explicit approval of pre-construction works with an ex-ante allowance for defined high-level deliverables is a suitable approach for discovering information on the cost and performance of potential reinforcement works.

An opex approach to funding ensures that the pre-construction works do not add to financeability issues in the TPCR4 period (which the initial proposals document identifies as an issue for some other companies). If a capex approach is adopted, then it is important that financing revenues commence at the same time that investment commitments are made (i.e. such costs should not be logged-up because the uncertainties associated with ex-post review make initiating such investments problematic). A compromise (like repex) approach might also be considered.

Question 3: Do respondents have any views on our proposed approach to identifying projects eligible for construction funding?

Subject to our observations about the nature of need evidence for the identified works given above, we agree with linking construction funding on an assessment of need; scope; timing; planning and technical readiness to proceed with identified works.

However, we suggest that the assessment of the planning aspect should not be as simple as “either has, or does not need, planning permission.” While this may be appropriate for a major item such as a new line, it may be unduly restrictive to require all consents at the outset for minor items where there may be good expectations of receiving consent or scope for making relatively minor modifications in order to secure consents. On this basis, the specific issues associated with obtaining planning permissions in a timely fashion should be assessed so that undue delay on initiating schemes is not imposed. (The use of conditional funding identified in paragraph 3.28 may address this point).

Question 4: Do respondents have any views on our proposal to fund construction costs up to the end of TPCR4 for specific projects? Do respondents agree that it may be appropriate to provide funding up to an earlier end date for projects in certain circumstances?

In principle, we agree that it is appropriate for Ofgem to retain an option to fund just that capital expenditure that occurs before a specific defined end point (be it at the end of TPCR4 or earlier). However, such end points need to be notified and/or chosen such that they align with decision points that can be agreed between transmission companies and their equipment suppliers. If such alignment cannot be established then transmission companies will face higher risks if they initiate works within the TPCR4 period and this could risk delays to progress. In practice the projects that are funded within TPCR4 may well result in commitments to incur costs within TPCR5 and this should be recognised.

Question 5: Do respondents agree that the same rate of return should apply as for other investment undertaken within TPCR4?

National Grid agrees that, subject to there not be significant additional risks resulting from the regulatory framework itself, the same rate of return should apply as for other investments undertaken within TPCR4.

However, we note that if the exposure to incentivisation is increased to 50% and if the measures of deliverables adopted do not align with decision points that network companies can agree with their equipment suppliers, then there is scope for significant additional risks which transmission companies will not be able to control (other than by delaying the investments).

In practice, much of the investment within the TPCR4 period will relate to just the initial stages of establishing a reinforcement scheme. The milestones or other measurements of deliverables that are chosen should ensure that large financial penalties do not arise for programme changes which represent alternative ways of delivering the overall project outputs (potentially in TPCR5). We therefore suggest that the deliverables/milestones are chosen such that they can be used in a high level assessment of the overall progress towards final delivery.

Question 6: Do respondents have any views on the appropriate treatment of projects beyond TPCR4 or on any interaction with our decision on the timing of TPCR5?

For the reasons we have stated above, we think it is in the interest of customers to establish, as soon as possible, a long-term framework which clarifies network company responsibilities and establishes appropriate incentives so that transmission companies appropriately manage their businesses and avoid a drift to relying on regulatory micro-management.

Question 7: Do respondents have any comments on any other aspect of our Initial Proposals?

Although the concept of agreeing a schedule of deliverables against which transmission company performance can be measured and incentives implemented is sound in principle, its operation in practice will depend on whether suitable deliverables can be agreed for each of the specific projects. As noted above, ideally such milestones would align with decision points that transmission companies may agree with suppliers (and stage payments between transmission companies and equipment suppliers would also relate) and also assist in performing an assessment of overall progress to full delivery. If such alignment between deliverables and contractual arrangements cannot be achieved then transmission companies will be required to accept additional risk without scope for their control in the supply chain.