

PRICE CONTROLS AND INCENTIVES UNDER BETTA, AN OFGEM/DTI CONSULTATION, OCTOBER 2003

SP TRANSMISSION RESPONSE

1 Introduction

SP Transmission welcomes the opportunity to respond to this consultation on price controls and incentives under BETTA. We believe there is significant development work required in this area and we look forward to participating in this process.

The final arrangements depend critically on the introduction of new legislation through the Energy Bill, the modification of the current transmission licences and the re-drafting of certain industry codes and documents. We are already supporting those objectives by participating in expert groups and by providing responses to public consultations.

The challenge facing us in completing all necessary activities for the planned BETTA go-live date of April 2005 is certainly not underestimated by SP Transmission. Hopefully this response will provide some assistance in meeting those objectives.

However, we believe that the allocation of functions to the GBSO and to the Scottish TOs is not sufficiently well developed to allow, at this stage, significant progress on the development of price controls and incentives. The publication of this paper does not in itself represent significant progress in the BETTA project. To allow price controls and incentives to be developed there needs to be significant progress made in other key areas, such as:

- the finalisation of the STC;
- risk allocation;
- confidentiality;
- socialisation of the Scotland-England interconnector;
- investment planning for renewables; and
- planning standards.

These areas need to be fully addressed in the forthcoming papers on TO price controls.

2. The Current Price Controls

2.1 Durations of the current incentive schemes.

There will be some advantages in synchronising the price controls of the GBSO, NGC's TO business and the Scottish TOs. For example, the GBSO's cost targets will be set by taking into account the likely costs of running the system, which is dependent partly on the amount of transmission capacity available. The capacity available is, in turn, dependent on Ofgem's view of an efficient level of investment on the Scottish network. Given this interdependency it would seem to be inefficient to set the GBSO's cost allowance not knowing the level of investment for future years.

However, it is apparent from the paper that the duration of the existing price controls has been somewhat variable. The GBSO has had three one-year schemes whereas the last Scottish TO scheme lasted six years, following some adjustments, and the current scheme may last seven years, also with some adjustments.

At this stage we are unconvinced that these radically different schemes can be synchronised. Our view is that a longer duration can introduce significant risk to the licensees and could result in customers waiting longer to see the benefit of any costs savings. On the other hand, a shorter duration does not create a sufficient incentive for the licensees as any efficiency is quickly removed for the benefit of customers. Our view is that if the desire is to synchronise all incentive schemes it will ultimately be up to the GBSO to consider accepting a longer scheme.

2.2 The Form of the Price Controls

We agree that NGC's SO incentive scheme is unique in GB. The Scottish TOs do not have a similar scheme but are funded for some similar activities under our RPI-X schemes.

Much of what was termed 'SO costs' at the last Scottish transmission review relates to activities which are currently funded under the NGC TO scheme in England & Wales. Examples are safety switching, outage planning and operational co-ordination. As such, these activities will continue to be a TO responsibility under BETTA and need to be appropriately funded.

The introduction of BETTA has introduced a new interface between the TO & GBSO and eliminated an efficient TO & DNO interface. It is well known that the Scottish companies have

integrated their transmission and distribution businesses in recent years, with the resultant cost savings being passed on to customers. Some of these savings will be reversed under BETTA and the additional costs imposed by introducing a new interface will need to be borne by Users to allow efficient funding of the Scottish TOs. So, in our area there will be a formal interface created between SP Transmission and the GBSO and the GBSO and SP Distribution. As an example, any discussions relating to the modification or construction of a Grid Supply point will be TO to GBSO and GBSO to DNO. This additional cost will need to be financed.

2.3 Excluded Services

The consultation paper correctly points out that all licensees are allowed to earn revenues for the provision of certain transmission-related excluded services as set out in their licences. These arrangements are in place because of the unpredictable nature of these services (i.e. they are so difficult to forecast they could not be included in a price control settlement) and because the services are generally required by an identifiable individual party. It is our view that these arrangements should continue under BETTA. Examples are the provision of new connections, the rental for fibre-optic telecommunication systems and the provision of pre-application studies.

3. Form of Controls under BETTA

3.1 Revenue flow

Under the current Ofgem/DTI proposals the GBSO will collect all revenues from Users. These revenues will be used to fund three Licensees, for TO activities and SO activities.

Under the current charging methodologies in GB the cost of funding each activity is reasonably transparent. It is possible for Users to analyse the Licensees' costs over time and form a view on their efficiencies. However, if activities are bundled together, as suggested in paragraph 3.18, this transparency could be lost. We would welcome further discussion on the intention behind that paragraph.

3.2 STC income adjusting events

We note the suggestion that certain changes to the allocation of activities under the STC could trigger changes to the Licensees' allowable revenues.

At this stage we see three possible reasons for adjusting TO revenues under BETTA:

- a) A re-allocation of activities under the STC;
- b) As a result of a TO's performance under its incentive scheme; and
- c) As result of an action carried out to meet the request of another STC party, the need for which is not addressed by the incentive scheme.

We see no reason why a) and b) should not be addressed by the revenue restriction licence condition. This is mainly due to the fact that there should be a degree of consultation on changes of this type. However, we see that c) could be appropriate for an STC income adjusting event but we would like to consider it further as the work progresses.

3.3 Two Part Revenue Restriction

We note that Ofgem considers it appropriate for the Scottish TO price controls to have two parts - an RPI-X control and TO incentives. We are unclear why this is characterised as a two part revenue restriction. There are many factors taken into account in arriving that maximum allowable revenue for electricity network businesses in any year, such as the value of RPI, system performance, units distributed, losses and bad debt adjustments. The introduction of a new factor does not require the creation of two parts to the price control. We see this as unnecessarily complicated.

3.4 Scottish TO Revenues under BETTA

Paragraph 3.7 and footnote 24 correctly point out that those transmission activities currently remunerated under NGC's TO price control and the activities that will be undertaken by Scottish TOs under BETTA are unlikely to be identical. For example, Ofgem/DTI considers that transmission switching model A2 represents a workable solution for BETTA. Under this model all GBSO switching instructions would go via the TO control room. It would seem appropriate that while this activity should be funded under the Scottish TO price controls the associated revenues should not be collected from Users through TNUoS charges. BSUoS would be more appropriate.

A key part of this process will be to set these revenues at an appropriate cost-reflective level.

4 Adjusting NGC's Revenue Restriction for BETTA

4.1 Deep SO Incentives

In Ofgem's initial consultation document on NGC's SO incentive scheme (October 2002) it was suggested that the scope of the scheme should be extended to cover not only its operation of the transmission system but also the development of the system – the so called “deep” incentives. It was proposed that the scheme would provide NGC with appropriate commercial incentives to respond to signals from market participants concerning their requirement for transmission capacity and encourage efficient and timely development of the transmission system.

There was very little industry support for this development. Most respondents supported the extension of the shallow arrangements, stating that there was no convincing argument for the introduction of a deeper scheme and that they did not believe that development of a deep incentive scheme would deliver the claimed benefits.

Given the industry opposition to such a scheme, and bearing in mind the Ofgem/DTI decision that TOs should be responsible under BETTA for transmission planning and development, we see no justification for considering the introduction of deep SO incentives in England & Wales prior to the introduction of BETTA, as is discussed in paragraph 3.31 of the consultation paper. To deepen NGC's incentives by introducing a capacity release incentive scheme in 2004 will create a model which pre-empts the outcome of the BETTA debate regarding the SO/TO relationship.

The NGC SO incentive scheme due to be introduced from April 2004 should be shallow and should remain so until after BETTA go-live. Deeper incentives should only be considered after the roles of the GBSO and Scottish TOs are well established under BETTA, and should be subject to rigorous cost benefit analysis.

4.2 NGC revenue changes

We support the proposal in paragraph 3.32 that changes to the revenue required by NGC in moving from its current role to that of combined GBSO/TO should be provided through adjusting the allowable revenues under each part of NGC's existing revenue restrictions. That modification should preserve the transparency currently available to Users.

In doing so, we believe it would be necessary to reconsider the allocation of costs to the Part 1 and Part 2 components. The costs associated with GB wide activities should be allocated to the Part 2 component. Given that the cost of activities associated with the CUSC, Grid Code, developing GB charging methodology and the BSC do not vary according to the location of Users, it is not appropriate to collect the associated revenues through locationally varying TNUoS.

4.3 Bundling transmission activities

We support the option described in 3.34 for adjusting NGC's revenue restrictions under BETTA. It is important that Users remain aware of the costs of funding the two main types of transmission activities. That transparency will remain by incrementing NGC's Part 1 revenue restriction to collect sufficient funds for the remuneration of the Scottish TOs and NGC's TO business and by incrementing NGC's Part 2 revenue restriction components to take into account the costs of operating the entire GB system rather than just the England and Wales system.

This can be achieved by providing a link from the Scottish TOs' revenue restriction licence conditions to the GBSO's revenue restriction. We would not favour a mechanism for revenue setting to be contained within the STC. Revenue setting is a matter between Licensees and the Authority.

4.4 Additional costs arising from TO services

Should the Scottish TOs provide additional services at the request of the GBSO which are not remunerated under their price controls, as described in paragraph 3.36, then clearly those services must be of value to the GBSO through reducing its balancing costs. There can be no question that Users would pay additional costs to avoid larger costs.

4.5 Consistent sets of activities

While we agree that consistent sets of activities should be remunerated under the same parts of NGC's price control we believe the starting point is wrong. NGC's Part 1 revenue restriction should not be incremented to include the Scottish transmission activities but rather the revenue associated with NGC's GB obligations should be subtracted from NGC's Part 1 revenue, which should then be augmented by the Scottish TO 'Part 1' revenues. NGC's Part 2 revenue should

then be increased with the addition of any revenues associated with SP Transmission or SHE Transmission 'Part 2' system operation revenues.

We note in paragraph 3.39 that Ofgem/DTI believe one justification for remunerating consistent sets of activities for each Licensee is that it will enable comparative analysis to be carried out. While we believe there is merit in bundling consistent sets of activities it is worth mentioning at this stage that comparative analysis of the GB transmission Licensees has never been effective, unlike the comparisons of the businesses of the GB distribution Licensees. The three transmission Licensees are radically different in terms of maximum demand, voltages, revenue requirements and investment levels, to name but a few network and financial characteristics.

4.6 Correction factor

We agree that it is desirable that the amounts of revenue under or over recovered in 2004/05 are minimised. Given the form of the controls in Scotland it will be possible to get very near the maximum allowable revenue. If an over-recovery was looking likely then that could be addressed through rebates before the year-end.

What is of greater financial significance, given the much larger revenue allowance, is that NGC does not have a significant under-recovery in 2004/05, which is carried over to 2005/06 and collected from across GB.

The general principle which should be applied is that any under or over recovery in 2004/05 is rectified by setting appropriate charges in 2005/06 for those sets of customers who benefited or suffered from the 2004/05 charges.

5. Process and Timetable

5.1 Background

The first Scottish transmission price controls were put in place by the Government for the four year period April 1990 to March 1994. OFFER put in place the second Scottish transmission price controls for the five year period April 1994 to March 1999. While OFFER initially believed there was some advantage in examining each regulated business separately it was decided late in 1997 that they wished to deal with all six network businesses of the two Scottish companies in one review. After consulting the companies, the duration of the second Scottish transmission price

controls was extended by one year to a total of six years. The current controls began on 1 April 2000 and end on 31 March 2005.

The setting of the third transmission price controls in Scotland took around 18 months. Allowing six months for a Competition Commission referral the current process should have begun around March 2003. (The distribution review process is well underway and transmission should be following the same timetable.)

It is clear to us, therefore, that there is no time remaining to conduct a full business review and agree licence changes before 1 April 2005 for a new five-year control. The decision to extend the current control has, in effect, been made.

5.2 Interaction of price controls and the STC

Funding of the Scottish transmission companies depends critically on the content of the STC and the drafting of new licence conditions, as acknowledged in the consultation paper. Only when we know the rights and obligations of the companies will we know the level of funding required. While significant progress has been made in developing the STC and the new licences many key issues remain outstanding. The confirmation of planned dates for the issue of consultation papers does not provide comfort that these issues can be resolved in time.

Knowing the challenging issues being tackled within STEG and the licences discussions, we find the timetable set out in paragraph 4.14 unrealistic.

5.3 Transmission owner incentives

The introduction of the BETTA incentive regime brings with it new risks for the GBSO and the Scottish TOs. The process of identifying, quantifying and allocating these new risks will be a demanding task and a successful outcome will depend to a certain extent on how the market responds to the introduction of BETTA. In general, the setting of parameters for an incentive scheme needs data on the environment in which the scheme will exist. Given our lack of knowledge of network demands under BETTA we would not favour a complex SO/TO interactive incentive scheme. In any case, there is insufficient time remaining to develop any form of complex incentive regime to be put in place for April 2005. We believe that any incentives to be introduced for BETTA go-live must be simple, easy to apply and largely operational in nature.

We look forward to the January 2004 paper on initial thoughts on the TO incentives. We would urge that a complex and interactive scheme is not considered for the early stages of BETTA as we believe it is unachievable.

We also note that initial proposals are planned for publication in April 2004. We are committed to working with Ofgem/DTI and the other transmission licensees to develop incentives under BETTA but at this stage the development of initial proposals by April 2004 seems improbable.

We also note the proposal in paragraph 4.17 that the GBSO's incentives will be developed to a later timetable. This highlights one of the current difficulties of BETTA. The GBSO has not been designated at this stage and therefore it would be inappropriate to consult on how its incentives may be set, as the likely GBSO may be somewhat constrained in framing its response. However, we believe that while we are not in favour of an interactive incentive scheme we need to take an integrated approach to developing all incentives under BETTA. After all, the Scottish TOs will no doubt have views on the GBSO's incentives and vice versa. We do not see how each set of incentives can be developed in isolation.

5.4 Contingency planning

We recognise Ofgem/DTI's concerns about the need for contingency planning, given the number of unknowns relating to the introduction of BETTA. However, we feel that the situation that we are now in has been brought about by making a key assumption - that the Scottish Licensees are in agreement that their price controls should be extended by either one or two years.

When Ofgem/DTI decided that they wished to extend the current price controls that option should have been put to the Licensees in plenty of time to conduct a full review had they not accepted the proposal. We are now in the position that if a Section 11 notice is issued for a licence modification for one year, and it is rejected by the companies, then a Competition Commission referral is unavoidable. If the outcome to that referral is that it would have been in the public interest to have a full review of the companies then time will not allow that to happen. Indeed, we believe we are already past the point where a full review is possible.

5.5 Potential delay to BETTA go-live

We note the view that arrangements will need to be put in place, possibly at short notice, if BETTA go-live is later than 1 April 2005. However, we take the view that no matter when

BETTA goes live, arrangements will need to be in place for 1 April 2005. The key question, therefore, is how the arrangements would differ if BETTA had or had not gone live by that time.

We note that the timetable set out in paragraph 4.29 describes a timetable for work related to developing price controls to be applied from 1 April 2005 until BETTA go-live which is almost identical to the timetable for developing TO price controls under BETTA. Our view is that it will be necessary to stick to these timetables but they are indicative of the difficult circumstances we find ourselves in, through no fault of the Licensees.

6. Work Programme

6.1 TO Incentives

We note the statement on paragraph 5.4 that TO incentives will be designed to support the GBSO in meeting its incentives. We see the TO's role as more than supporting the GBSO.

Under BETTA the TOs will be making their assets available to the GBSO to operate the GB transmission system and are also responsible for planning and developing the network in their licensed areas. If the TOs are incentivised to perform those functions well then it will increase the overall efficiency of the transmission sector for all users, without being a perfect fit with the GBSO's obligations.

Taking losses as an example – the GBSO can reduce losses through its choice of bid/offer acceptances in the balancing mechanism. The TOs can reduce losses by investing in low loss equipment. These do not fit well together. If system losses are reduced through investment or network reconfiguration, that does not support the GBSO in its role. It simply reduces losses and provides a different starting point from which the GBSO can reduce them further through the BM.

6.2 Allocation of functions between transmission owners and the GBSO

We agree that under BETTA the GBSO will undertake a greater range of activities, reflecting its role as combined system operator/transmission owner, and SPT and SHETL will undertake activities as transmission owners. However, we do not agree that SP Transmission and SHETL will necessarily be over-funded against their licensable activities. That statement makes assumptions about the design of BETTA, which is not yet settled.

The TOs will have new duties under BETTA brought about by additional interfaces and licence obligations. We should await the outcome to the work about to be commenced before making assumptions about the level of revenues required to finance the Scottish TOs.

6.3 Implementation costs

We agree that the full BETTA set-up costs may not be established prior to the agreement of the new price controls. However, small adjustments to the revenue allowance within a price control period have not been difficult in the past and that should not be ruled out.

We agree, as stated in paragraph 5.14, that NGC's Part 2 component would be the most appropriate means of recovering BETTA set-up costs.

6.4 Planning and operating standards

As stated, the Licensees, along with Ofgem, are looking at planning and operating standards under BETTA. We should await the delivery of that work and then take it into account in the new price controls.

6.5 Treatment of connections

The treatment of connections under BETTA is being considered by the STEG development groups at this time. That may well lead up to the redefining of connection and use of system boundaries. To what extent that impacts on past capital contributions is not known as yet and we should await the completion of that work.

Given the objectives of BETTA, common connection charging arrangements should be applied across GB. That does not mean that the methodology applied by any one Licensee should be adopted for all. There are strengths and weaknesses in the methodology currently applied by each Licensee and these should each be considered carefully.

6.6 Treatment of Scotland-England interconnector assets

The paper correctly points out that the interconnector assets in place at vesting are contained within the regulatory assets value. Since then, the interconnector has been upgraded twice, on the request of users. (SP Transmission is currently obliged to offer terms for interconnector upgrades, as set out in its licence.) We see the work associated with incorporating these assets

into the general asset base as extremely important to SPT. We also agree that there are similarities with the proposed treatment of post-vesting connections.