☰ Scottish and Southern Energy plc

Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ

David Halldearn
Director, Scotland and Europe
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Tel: 01738 456400
Fax: 01738 456415

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Dear David,

Price Controls and Incentives under BETTA - Ofgem/DTI Consultation

Before commenting on the particular issues raised in the above consultation, we have a number of concerns about the overall process.

In particular, we are concerned that the "interim" review is beginning to look like a full price control review for the period from April 2005 until the proposed aligned review in 2007. For example a large draft business planning questionnaire has been submitted to the company for comment. We would regard a full review for two years as unacceptable. The incentives to reduce costs need to be preserved and this cannot be achieve with, in effect, a two year price control.

However, we recognise that some changes are required in advance of the full review proposed for 2007. We believe these can be addressed in each of the three work areas as follows.

(i) Main TO price control. We believe that Ofgem simply need to undertake a broad due diligence analysis (e.g. from the regulated accounts) to check that overall returns are reasonable.

(ii) BETTA. Other than the interconnector (which can be dealt with through a one-off adjustment in the interim) there will be no reduction to the basic TO costs. Indeed, we firmly believe that any cost reduction arising from reduced activity in system balancing will be more than offset by increased costs in co-ordinating with the GBSO. As a consequence, we see no reason to adjust the TO price control to reflect the new split of responsibilities. Incentives for TOs to assist the GBSO will not require changes to the main TO price control. Instead a new set of processes and arrangements will be required as outlined in this consultation as "Part 2" of the TO control. However, there will need to be an adjustment in respect of BETTA implementation costs. But we believe that this could be achieved by putting such costs into the GBSO's cost recovery "pot" and recovering them through non-locational charges.

(iii) Transmission investment for renewables (RETS). This requires a separate adjustment as proposed in our letter to Richard Ford.

We therefore believe that, overall, a simple roll forward of the TO price control could be achieved, with separate add-ons for RETS, socialisation of the interconnector, BETTA implementation and TO incentives.

We have set out below our more detailed thoughts on the incentive mechanism and the form of the controls going forward.

Form of Price Controls

NGC

We agree that the form of NGC's price control should remain broadly the same as the present mechanism in E&W, which contains both SO and TO components. However it is important to capture all of the new costs resulting from BETTA. In particular, the SO incentive scheme should include the internal costs of system operator activities across GB to reflect the revised scope of the GBSO. The SO incentive will also need to be amended to reflect the external costs across the whole of GB of balancing services. Given that there will be no historic basis for estimating the Scottish balancing costs, it may be necessary to have a high degree of pass through for a short period to gain experience of operating the Scottish system.

There will clearly be an interaction between the SO incentive and the services provided by TOs, including NGC as a combined SO/TO. This exists at present, and NGC makes decisions every day based on whether additional costs in its "TO" business should be incurred in order to reduce the costs of balancing services. These interactions are further discussed under the TO part 2 incentive below.

Similarly, the element of NGC's price control representing its TO activities needs to reflect the revised scope of its activities.

However, while we agree that the form of the control should remain basically the same, we believe that it would be helpful if the terminology was amended to reflect mechanisms that will be in place under BETTA. In particular, we believe that the Part 1 revenue restrictions should be termed the "transmission services revenue restriction", which would then match the services that the Scottish TOs will provide under the STC, and which will be remunerated by NGC.

Since it will be a system operator licence activity to establish the GB charging arrangements and the SO incentive scheme will include the costs of SO activities, the costs of these commercial activities will clearly need to be within the scope of the SO price control cost recovery. It is not clear, therefore, that NGC's part 1 revenue restriction should be incremented to include Scottish costs. Instead, we believe that each of the three licensees "Part 1" restriction should determine their costs of providing transmission services. NGC, in setting GB-wide tariffs as the system operator, could then incorporate the three sums (NGC, SP and SSE) in the revenue recovery target in the same way that DNOs incorporate NGC exit charges into their DUOS tariffs.

We believe that this distinction is important in considering the incentive arrangements that may be required.

Scottish Companies

Part 1 arrangements

We agree that the main part of the TO price control should comprise an RPI-X control similar to that in place at present. However, there are features of the BETTA arrangements that will need to be considered in setting this element of the control. Firstly, the contractual arrangements under BETTA and secondly, the different cost recovery mechanisms employed by NGC in its existing charging methodology.

In the new contractual arrangements, NGC will be responsible for recovering connection charges from users according to their charging methodology. There will be no direct linkage between the revenue recovered by NGC, and the sums that NGC pay to TOs under the STC for these connection assets. Under the present Scottish transmission price controls, connections are an excluded service revenue. We would anticipate the same principles to apply posts BETTA, and given that SSE has obtained full up-front payment for all new post vesting connections, we would expect NGC as GBSO to pay the full capital cost of the element of a new connection that NGC will be charging to new users under the GB CUSC.

The second issue relates to the boundary between connection and infrastructure under GB charging arrangements. NGC have a shallow connection policy, and has recently proposed moving even shallower by using the "plugs" mechanism. This implies that with any new connection the element to be charged directly to the customer will be relatively small, and any part of the connection works that could be construed as shared assets would be treated as infrastructure. As a consequence, the TO price control would require a facility for adjustment to reflect the infrastructure element of new connections work.

Part 2 arrangements

Ofgem has also proposed a "part 2" price control mechanism to cover potential incentive arrangements between the GBSO and the TOs. While we understand the need to ensure that efficient decisions are taken in managing the GB transmission system, we do not believe that this requires a complicated incentive mechanism.

In designing the mechanism, we believe the objectives should be as follows:

(i) TOs should only be directly exposed to costs that they can control. In particular, it would not be acceptable to expose Scottish TOs to balancing costs of the GBSO.
(ii) Any mechanism must not provide inappropriate incentives for the SO to push balancing costs (for which it would be remunerated under the separate SO incentive scheme) onto the TOs.
(iii) However, the GBSO should not be unduly exposed to costs due to failure on behalf of the TOs to plan, develop and maintain an efficient transmission system; and
(iv) The arrangements should be simple both to implement and to audit.

We believe that this could be achieved under BETTA by a combination of licence obligations and commercial arrangements. The latter could incorporate both schedule rates and contractual arrangements so that any "abnormal" costs incurred by a TO at the request of the GBSO could be identified either in advance, for prearranged work, or from the schedule rates for emergency work. These additional costs would then form an additional excluded service element of transmission services provided by the TO. Similar arrangements would need to apply to the GBSO to ensure that it can recover costs incurred under this mechanism. We look forward to further discussion with Ofgem on these arrangements.

Other Issues

We agree that both NGC and TO price controls should include STC related income adjusting events.

It is not clear that any special arrangements are needed to ensure that under or over recovery of revenue for 2004/5 is minimised. The main source of error for transmission revenues tends to be in the peak demand forecasting, although in 04/05 there is an additional risk relating to the number of new generators that will connect and become liable for TNUOS. However, we expect the effect to be small and do not foresee any requirement for special provisions.

If you have any questions on the above please give me a call.

Yours sincerely,

Rob McDonald
Director of Regulation