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**Transmission investment and renewable generation –  
Consultation document – October 2003**

***A Response by British Gas Trading***

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## 1. Introductory Comments

British Gas Trading (British Gas) welcomes the opportunity to respond to Ofgem's consultation in respect of 'Transmission investment and renewable generation' and is happy for this non-confidential response to be placed in the Ofgem library.

## 2. Summary

The views contained in this response are British Gas' initial thoughts. A more considered view will be presented once we have seen more information on the likely range of costs and the likely effect on charges.

British Gas does not consider that a compelling case has yet been made to amend the existing price controls for all three licensees. In the absence of such a case, we propose that the additional costs of renewables be 'logged up' and considered at the next price control, where the use of benchmarking techniques could be employed to assess the efficient level of costs.

However, if the existing price controls are to be amended, then: -

- We do not consider that it is appropriate to fully reopen the existing price controls in light of the considerable time and effort required to do so; and
- Consideration should be given to the partial reopening of the price controls, either
  - Along the lines of that used in the water industry by Ofwat; or preferably
  - The modified Ofwat approach described later in this response;

Because of the current uncertainty in renewables unit costs and volumes, the latter two approaches could be complemented by the introduction of a simple hybrid incentive mechanism (an 'alternative mechanism') along the lines of that proposed by Ofgem for the incentivisation of electricity distributors with respect to the connection of distributed generation.

## 3. Detailed comments

### 3.1 Price controls

Price controls should only be amended in very exceptional and clearly defined circumstances. A key example of this would be where factors outside the control of the licensee, including changes in legislation or government policy, would otherwise mean that an efficient licensee would not be able to finance its activities or where the effect of changes in circumstances outside a licensee's control were above some materiality threshold over a number of years. Another example might be where the existing incentives were such that the likelihood of the delivery of certain important outputs would be considerably reduced. To open price controls in any other circumstances could seriously undermine the regulatory contract, introduce unnecessary risk and impact the incentive properties of the existing five-year RPI-X type price controls to the detriment of end consumers.

#### 3.1.1 Financial considerations

The potential financial implications on the licensees would appear to be significant compared to their annual turnover especially if the existing price controls are extended. This is particularly the case for SHETL though to a much lesser extent for NGT. However,

the consultation document does not explicitly state that the licensees would not be able to finance their activities. Furthermore, it is not clear which of the licensees would fail the necessary financing test during the existing price control period as compared to the situation where the existing controls are rolled forward. It is also not clear whether the figures provided in the consultation document include or exclude the effects of generator connection charge contributions. Ofgem's clarification on these points would be welcome.

Subject to the above clarifications, the potential additional effects of a greater volume of renewables than that assumed when setting the original price controls appear to be substantial. However, there is no countervailing information to show whether or not transmission operators' costs have reduced in other areas as a consequence of outturn reductions to other assumptions underpinning the price control. Any materiality test, hence any increase in revenues, might include the net effect of all changes to all key assumptions underlying the price control.

### 3.1.2 The government's environmental targets and aspirations

In addition to the financing of activities, Ofgem has rightly pointed out the need for the regulatory regime to facilitate (though importantly not to meet) the government's environmental targets and aspirations. This is via the obligation on Ofgem to have regard to any environmental guidance produced by the government. Whilst we accept that there could be a risk that if the additional costs were rolled forward until the following price controls then the uncertainty in cost recovery could reduce the incentives on the transmission operators to facilitate these additional connections; it is unclear whether this effect would be material in light of the duty on the TOs to make the relevant connections.

### 3.1.3 Possible principles and objectives

#### *Materiality*

Ofwat allows interim price re-determinations where the net effect (increases and decreases) of movements in predefined categories of costs is greater than 10 per cent of turnover over a number of years. These rights are enshrined in the companies' licence conditions. As the ability to seek price re-determinations with respect to renewables costs is not covered by the existing electricity Transmission Operators (TO) licence conditions then any amendments within a price control period appear to require the need to satisfy a much higher materiality threshold. That is, where increases in the efficient level of costs as a consequence of factors outside an electricity TO's control are less than the higher materiality test, those costs should be logged up for appropriate treatment at the next price control. It is for consideration what is an appropriate percentage of turnover and number of years.

#### *Ability to finance*

The above materiality threshold should also be complemented by a financing test. That is, where a company is not able to finance its activities or potentially would not be able to maintain an investment grade credit rating, after taking account of the company's efficient costs, consideration should be given to amending the existing price control. The test here should be on the basis of the prevailing estimate of efficient costs and not the costs estimated in setting the original control. This should mean that the financing test uses costs that are net of efficiency savings to date and expected (e.g. lower than assumed operating expenditure or cost of capital) plus the additional costs of the change in circumstances. Care would need to be exercised to ensure that this did not provide

perverse incentives on companies to pursue unstable capital structures, at lower cost to them, in the knowledge that Ofgem would protect them from even small cost shocks.

### *Extension of existing price controls*

The information provided by the electricity TOs shows a greater cost effect if the existing price controls are rolled forward. This suggests that it might be appropriate to log up a particular company's costs if the price control is not extended, as opposed to amending the control if the control period is extended.

This would imply that the extension of the existing price controls and amendment of the existing price controls is intrinsically linked. If that is the case then the two issues should be considered together, rather than the current position of separate but related consultations. However, if the extension of the existing price controls will include the updating of the existing assumptions underlying the renewables costs, then the two decisions can be taken independently, i.e. only the treatment of additional renewables costs during the period of the existing controls needs consideration.

This interaction and interdependence requires further consideration. We would welcome Ofgem's initial thoughts on the treatment of renewables costs where the existing controls are extended.

In light of the above comments and the information provided to date, we are not yet persuaded that there is a compelling case to amend the existing price controls of all three electricity TOs.

## **3.2 Ofgem issues for consultation**

### **3.2.1 Rely on existing mechanisms**

#### *Do nothing until the next price control*

In the absence of a compelling case for a price control amendment, the costs could be 'logged up' until the next price control. The letters of comfort provided to the Scottish TOs earlier this year appear to provide a suitable mechanism to achieve this process. At the next price control review, the outturn costs could be benchmarked across the three licensees so that the relevant proportion of the net additional efficient level of costs are recovered. Though the incentive properties of this mechanism would not be as strong as RPI-X, it would still be superior to that of standard pass through.

#### *Deep connection charges*

We agree with Ofgem that it would not be appropriate for the transmission operators to move to a deep connection regime to allow them to fully recover the cost shortfall that would otherwise occur as a consequence of the increased levels of renewable investment. There are three reasons that this change would not be appropriate. First, the use of deep connection charges does not strike an appropriate balance between the need to provide connectees with locational signals versus equitably sharing the costs of reinforcement assets between all potential users (demand and generation) of those assets. Second, depending on the exact methodology to be used, deep connection regimes could effectively amount to a cost pass through mechanism. These mechanisms have very weak incentive properties and should only be used where the licensees have no control over the level of costs. The cost as a consequence of connecting renewables is clearly a

controllable (rather than uncontrollable) cost. Third, a change to deep connection charging would amount to a change in the price control, i.e. a price control change through the back door. If it was appropriate to amend the price controls, there appear to be superior methods of doing so.

### 3.2.2 [Fully] Re-open the price controls

Fully reopening price controls has the advantage that the cost increases, as a consequence of renewables, can be balanced by the cost decreases, which may have taken place elsewhere within price controlled activities. The disadvantages of this approach include the significant time and effort required to produce a new price control and the effective early capturing of all efficiencies. The latter would significantly reduce the incentive properties of the control. We consider that these dis-benefits outweigh the benefits and would not support such a move.

### 3.2.3 An additional mechanism

There is some merit in an additional mechanism, as suggested by Ofgem's consultation document, to incentivise renewables connection in light of the apparent considerable uncertainty in the likely volumes and unit costs of those renewables. However, on its own this might have the effect of creating an asymmetrical risk in favour of licensees to the detriment of customers. This asymmetry arises out of the consideration only of the additional costs arising as a consequence of renewables rather than the consideration of the net effect of increases and decreases to costs as a consequence of changes to other price control assumptions.

In the next section we consider how such a mechanism might be combined with other changes.

## 3.3 **Alternatives**

While it is important not to undermine the incentive properties of RPI-X regulation, it is also important to ensure that any price control re-opening has a symmetrical application. Licensees must not be allowed to cherry pick those assumptions from which they had lost financially even if there were others from which they had gained. For example, say in the case where for two assumptions underlying the price control if the outturn of one of those parameters is negative (as a consequence of factors outside its control) and the other one positive; any additional cost allowance required could be considered to be the net effect of the two changes.

### 3.3.1 Ofwat approach

Ofwat has two predetermined methods of dealing with cost changes.

First, there is a symmetrical interim price re-determination route via: -

- Ofwat as well as licensees being able to seek a re-determination of revenues; and
- Any resulting price changes taking account of decreases as well as increases in the costs of licensees as a consequence of changes in a number of assumptions underlying the price control, i.e. the net affect of changes to underlying assumptions.

Any price re-determination also has to pass a materiality threshold over a number of years.

Second, specified categories of changes to costs can be logged up until the next price control.

Ofwat has recently considered a number of re-determinations. Further details of Ofwat's approach and the timescales involved can be found by reviewing the 5 November 2003 Ofwat draft decision in relation to Northumbrian Water which was made approximately two months after the initial application by the licensee.

However, we accept that the problem with applying this approach to the electricity TOs is that it is far from clear what assumptions and activities underlying the existing price controls should be included in the analysis.

### 3.3.2 Modified Ofwat approach

A simplistic variation of the Ofwat approach would be to ignore all non-renewables activities (save to the extent that the presence of additional renewables might reduce other costs). For the additional capital costs of renewables connection, an updated cost of capital and annual efficiency factor (value of X) would be calculated. This would have the affect of keeping the original price control intact, whilst providing additional funding that was closely related to the prevailing efficient cost of meeting the new (changed) obligation.

### 3.3.3 [Modified] Ofwat plus 'additional mechanism'

If the Ofwat or modified Ofwat approach were to be employed we would favour the use of an additional mechanism in place of the standard RPI-X methodology. Our preferred mechanism is a simple hybrid incentive mechanism along the lines of that proposed by Ofgem for the incentivisation of electricity distributors with respect to the connection of distributed generation. This hybrid incentive mechanism has an element of pass-through plus incentivisation. It is similar in concept to the NGT electricity transmission SO incentive scheme that has a target price (cost) with an X percentage exposure to cost overruns and out performance around that price. The target price could be set on the basis of the level of expected efficient costs for each MW connected, whereas the X percentage could be set on the basis of the likely uncertainty (controllability).

The target price would address (incentivise) the volume uncertainty, whereas the X percentage exposure would address (incentivise) the unit cost uncertainty.

## 3.4 **Required investment**

It would be helpful if the forecast renewables cost information could be split between the likely upfront connection charges and generation and demand charges.

The costs have been published as a point forecast. However, in light of the uncertainty involved in both volumes and unit costs, a better approach would be to present a range of costs/volumes including a central forecast. This information could be supplemented by some quantification of the level of uncertainty (both upside and downside) in the estimates. The latter could be used to set the X percent exposure in the hybrid incentive mechanism described earlier.

There would appear to be merit in benchmarking the individual components of costs across the three licensees. If appropriate this approach could be supplemented by the costs of connecting renewables, especially remote renewables, elsewhere in Europe.

**Tahir Majid /Regulatory Affairs/British Gas/ 20.11.2003**