

## **Transmission Price Controls and BETTA Update – May 2004**

### **Response by SP Transmission Limited**

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#### **Chapter 2 - the price control framework**

1. We comment below on the proposal to roll forward price control for a two year period, and on the treatment of investment planning, outages and other activities mentioned in paragraph 2.12. We note the discussion of issues relating to price controls if BETTA go-live is delayed beyond April 2005, and we look forward to further proposals for addressing this in due course.

#### **Chapter 3 - roll forward of price controls absent BETTA**

##### *Duration of price controls*

2. We can see some merit in the proposals for the roll forward of SPT's price control for a two year period. It is important, however, that treatment of both opex and capex take proper account of BETTA implementation costs, investment linked to renewables and other capital requirements over the period.

##### *Treatment of incentives*

3. As regards operating expenditure, we would expect that 2004/05 will be the benchmark year for the 2007 transmission price review. We support the principle of a 5 year rolling mechanism to apply to controllable cost savings made during the two year period 2005/06 and 2006/07. However, as with distribution, there is a case for applying a rolling mechanism for controllable opex savings achieved during the current price control period.
4. Paragraph 3.39 refers to the treatment of rates. We have dealt with this issue in our response to the Distribution Price Review Policy Paper of March 2004. We have been very active in the process of establishing revised rateable values to ensure that costs are minimised. We would therefore expect these costs to be treated as pass-through.
5. For capital expenditure, the picture is distorted by the extent of investment required to support new renewables generation that was not foreseen at the time of the last price review. These requirements will continue to rise over the next two years, and it is important that this is recognised in the process to roll forward price controls. We have responded separately to the paper on Transmission Investment for Renewable Generation, which sets out our position in more detail.

### *Pension Costs*

6. We have set out our position on pension costs in our response to the March 2004 Distribution Price Review Policy Paper. We would support addressing issues for transmission pension costs arising out of DPCR work as part of the 2007 price review unless these are of particularly material significance in the interim period.

### *Cost of Capital*

7. Our position as regards the cost of capital relevant to distribution is set out in some detail in our response to the March DPCR paper. The evidence referred to there suggests a fully post-tax weighted cost of capital at least 5.0%, and we would argue that this should be applied to Scottish transmission also.

### *Estimation of the RAV at 1 April 2005*

8. We do not see a reason to depart from the normal approach of rolling forward the previous (2000) RAV to take account of subsequent capital expenditure, subject to an appropriate efficiency assessment (i.e. before BETTA-related adjustments are applied).

## **Chapter 4 – BETTA price controls**

### *Enduring operating cost changes*

9. We are continuing to carry out work to identify the changes to operating costs as a result of BETTA. The detailed operational arrangements between transmission licensees will be primarily detailed in the System Operator/Transmission Owner Code (STC) and the System Operator Transmission Owner Code Procedures (STCPs), amongst other documents. Work is ongoing to finalise the STC for designation, although the detailed transmission licensee interactions will be contained within the STCPs.
10. Significant work still remains to be undertaken on the STCPs and until this work is further advanced, it is difficult to accurately forecast the changes in operational expenditure under BETTA. Although we will still be responsible for switching and outage planning, for example, there is still some uncertainty over the detailed allocation of activities and hence costs. There are likely to be cost savings in some areas and increases in others for TOs and until BETTA has been operational for some time it will be difficult to accurately assess the differences in costs incurred as a result of the new arrangements. At this stage, for the purpose of the two year roll-over price control, we believe it is reasonable to assume that there will be little overall change in net operating costs as a result of BETTA.
11. As regards the reference to rates in respect of interconnector operating expenditure in paragraph 4.10, since vesting our allocation of rates costs has been

on the basis of GAV. Accordingly, both the pre-vesting and upgrade charges for the Scottish Interconnector correctly includes a rates allocation. In order to ensure consistency when socialising the interconnector, and to ensure that all costs associated with the interconnector upgrade capacity are covered, the rates element attributable to the upgraded capacity must be added to our cost base when amending our price control for BETTA.

#### *Implementation Costs*

12. SP Transmission has played a full and active role in working with Ofgem/DTI and the other transmission licensees to develop and implement BETTA. We agree with Ofgem that some implementation costs may not have been finalised at BETTA go live. However, as more detail on BETTA becomes available as the STC and STCPs are advanced, and the transitional framework becomes clearer, implementation cost estimates will be refined. We would note that each of the transmission licensees has different requirements for implementation.
13. We believe that it is appropriate to allow transmission licensees to recover BETTA implementation costs, both capital and operating expenditure, and including financing costs, over the two year period 2005/06 and 2006/07.

#### *Treatment of connections*

14. We note in paragraph 4.20 that BETTA will involve the application of common connection charging arrangements to users of the GB transmission system and that, if based on the prevailing England and Wales arrangements, this will redefine the boundary between connection and system assets in Scotland. The re-classification of such assets could require significant changes to regulatory asset bases and therefore allowed revenues. Careful consideration is needed to ensure that disproportionate and unanticipated cash outflows do not take place which could impact on our ability to invest in our network.

### **Chapter 5 – England-Scotland Interconnector regulatory asset values**

#### *Cessation of Contracts for BETTA*

15. In considering the adjustment of the transmission licensees' price controls for the Scotland-England Interconnector for BETTA, we assume that there will be no termination amounts or any ongoing liabilities between the parties to the Use of Interconnector Agreement. The question of financial compensation for the transfer of the Interconnector circuits into the transmission licensees' RABs and the end of the commercial arrangements as a consequence of BETTA is a regulatory and price control matter.

### ***Interconnector Valuation Approach***

16. As Ofgem notes, the three transmission licensees jointly proposed that the current asset related charges be added to the price controlled revenues of each licensee. We note that Ofgem does not believe that this approach necessarily protects the interests of customers, since Ofgem believes that incorporating the assets into the price controls reduces the revenue and cost risks to which the companies are currently exposed. In fact there are powerful reasons for stating that such an approach does protect the interests of consumers and investors. SPT stresses that a key underlying principle in the treatment of the Interconnector is that the transmission licensees must be no worse off under BETTA. Accordingly the present cash flows for the Interconnector should be preserved.
17. It should also be noted that, (as the consultation paper recognises), the GB system operator will need to be able to operate the Interconnector as an integral part of the transmission system from 1 April 2005. The Interconnector is key in facilitating GB trading and transmission arrangements. Socialisation of the Interconnector, therefore, is a fundamental enabler of BETTA.
18. It follows that the Licensees' significant investment in the Interconnector is a key enabler of BETTA. The Transmission Licensees have invested significantly in the upgrades to the Interconnector. BETTA could not take place without the increase in capacity created by that investment.
19. SPT is supportive of BETTA but requires a fair settlement in moving from the present commercial arrangements to a socialised Interconnector. Socialisation must be based on the market value of the upgrade investment.
20. The current commercial arrangements for these upgrades represent a market-related commercial valuation designed to secure a reasonable return on the Transmission Licensees' significant long- term investments. These arrangements were created with full regard to the regulatory environment and were subject to regulatory oversight.
21. These arrangements were determined and agreed in a commercial environment and were subject to significant commercial scrutiny and negotiation. Any adjustment to the price controls of the Transmission Licensees must take full account of those commercial arrangements.
22. The arrangements reflect the almost identical nature of SPT's and NGC's investments in the Interconnector. NGC's and SPT's investments in the upgrades are indivisible. Neither investment would have made sense without the other. As

connected investments, they serve one common purpose to allow increased power transfers between Scotland and England. The treatment of the NGC and SPT revenue streams from the upgrades should therefore be the same.

23. Investors in SPT are aware of the terms of the investment in the Interconnector. Their interests must be recognised. Socialisation will affect present and future investor and capital market confidence in long-term investment in the GB transmission system. Expectations of future revenue streams are material, on the basis that investors in SPT and NGC have bought a stream of income, and part of that stream of income is derived from the Interconnector. Any damage to investor confidence would not be in the consumer interest.
24. The interests of investors have been recognised by the Authority in the context of price controls where it has been acknowledged that it is important to recognise investors' legitimate expectations of income streams.
25. It is not desirable to act in a way that harms investor confidence. Investors must be confident of earning an adequate return on future assets so that new capital can be attracted to the business. There is also a clear consumer interest in securing that appropriate investment in infrastructure is encouraged. Such investment is encouraged by the fact that the licences contemplate that investors are entitled to earn a reasonable rate of return on their investments, so that they are incentivised to invest. Actions that damage investors' confidence could raise the cost of capital and lead to price increases, or a lack of investment, that would not be in the interest of the consumers.
26. Utilisation of the revenues contained in the current arrangements as a socialisation value has additional benefits. It recognises the important wider consumer benefits that the Interconnector has brought. These include increased security of supply and greater competition in the generation and supply of electricity. It recognises that the Interconnector will continue to bring those benefits under BETTA. Those benefits are a direct result of the Transmission Licensees' investment.
27. A market-derived valuation approach is a standard approach that has been used by the Authority for setting network price controls. Such an approach should be used for setting the Licensees' price controls to cover socialisation of the Interconnector upgrades.
28. SPT believes that auctions, and/or a payment mechanism based on constraints would yield more than the current revenue streams and that those revenue streams can be viewed as sitting at the lower end of a market valuation.

### *Valuation approaches*

29. In the consultation paper Ofgem put forward a number of potential approaches to valuation. These include: -
- Depreciated RAV value
  - Market value
  - MEA value

We now comment on each of these valuation methods.

### *Depreciated RAV Value*

30. We welcome Ofgem's statement that this approach would not recognise the commercial nature of the licensees' investments at present. We agree with the statement that Ofgem has used market based valuations in setting RAB values, and would note that this has been an approach which has been used in price controls apart from NGC's. This approach has been endorsed by the Monopolies and Mergers Commission. We also agree that where market values are available these should be used as the basis of transferring assets from non-price control to price control regimes.
31. We also agree that it is important to recognise the existing regulatory framework. The terms of the Transmission Licence were of critical importance in setting the commercial arrangements surrounding SPT's significant investment in the Interconnector. SPT charges and charging statements are subject to regulatory scrutiny. The Transmission Licence requires the publication of a statement of Interconnector charges that is subject to approval by the Authority.
32. Shareholders investing in SPT will also have full regard to the regulatory background. Their investment decisions are made in light of the documents that regulate the business of SPT. The 1989 Act and the Transmission Licence in particular would affect investors' expectations. Investors would be aware of the terms of the Transmission Licence. Investors would be aware that the Transmission Licence provides for the supervision of and approval of charging statements regarding the Interconnector. They would be aware that licensees are entitled to obtain a reasonable rate of return on their investments.
33. In conclusion, depreciated RAV value is not an appropriate measure.

### *Market Valuation Based on Contract Cash Flow*

34. SPT welcomes Ofgem's statement that its preference is to use market based valuations as the basis for setting opening RAB values. SPT welcomes the recognition of the fact that the Interconnector has been developed as a commercial venture.
35. The commercial arrangements surrounding the upgrades represent a market-derived valuation of the network assets in question as the returns and terms were set on a commercial basis in a market context. Accordingly the revenue streams under the commercial arrangements represent a market value.
36. In ascribing a value to the revenue streams care must be taken not to revisit the commercial arrangements in such a way as to adversely affect the legitimate expectations of investors in the transmission licensees as to the value of their investments.
37. A range of assumptions can be used in determining the value of commercial arrangements. Such assumptions can be used to deflate or inflate the value of the commercial arrangements. In many cases different persons (having carried out due diligence) come to quite different views as to the true value of commercial arrangements. This is regularly seen in the electricity industry, in the context, for example, of the acquisition of power stations and supply businesses.
38. Investors have a legitimate expectation that once commercial arrangements are concluded the extent to which they can be reopened is limited and clearly defined irrespective of whether the assumptions used in entering into the arrangements prove to be favourable or not. Commercial arrangements are not generally subject to permanent review even if there are shifts in costs and future events, or indeed the outturn of future events is different to the predicted outturn.
39. If a review were to be carried out, the basis of such a review would have to be considered carefully. A review could not only consider downward factors. It would have to consider factors that would ascribe a higher valuation as well. This means that any review of the value of the Licensees' arrangements must be approached with the utmost care. Such a review would have to proceed to look at all current relevant factors. Such a review, despite certain perceived risk reductions could easily lead to an upward revaluation. SPT could have advocated a valuation approach based on the full economic benefits brought by the Interconnector based on constraints. This approach supports a value higher than the current valuation.

40. A fair and equitable settlement that reflects market value is to adjust the price control to fully recognise the revenues that the Transmission Licensees presently receive under the existing Interconnector arrangements. This is the approach that we believe is broadly suggested at paragraph 5.21 of the Consultation Paper. Such an approach properly respects investors' legitimate expectations. It would not exceed or damage those legitimate expectations.

#### MEA Approach

41. We note the discussion of an approach based on MEA.
42. We do not agree with the statements at paragraph 5.37. The gross MEA values do not reflect the true "business value" of the licensees' investments in the Interconnector. Such an approach risks creating inconsistencies with the approach of UK regulators in dealing with similar matters in the past. The application of an MEA approach in this type of context could lead to some perverse results. There are sound regulatory reasons for the application of a market / revenue based approach.
43. It is agreed that links between transmission systems must be procured on an economic basis. However we question the usefulness of the assertion that "theoretically, if new assets have lower costs these should be preferred over existing assets" in the context of regulated infrastructure businesses.
44. Such an approach presupposes that it is appropriate to strand existing investors' investments. It cannot be a relevant approach in a regulatory context. The Transmission Licensees made their investments under full regulatory oversight. The investments were made within a clear statutory framework requiring the regulator to have regard to the need to secure that licence holders are able to finance their licensed activities.
45. If it is appropriate to strand investors' investments in such circumstances then the risks of funding such businesses will be viewed as significantly increased, and the cost of capital would rise. Such an approach would not be in the consumer interest.
46. The assertion in paragraph 5.37 relating to theoretical substitution by new assets at a lower cost risks diverging from practicality. Electricity infrastructure assets are not readily substitutable. The 2200MW Upgrade was commissioned last year. The commercial arrangements were set in 1994. The project took ten years to complete for a variety of complex reasons such as planning rules.



47. In properly applying a new procurement test, based on the cost of acquiring a new asset for BETTA there would be costs above the MEA of the assets in question. As an example, pending construction constraint costs would be significant. Given the industry's actual experience in this context it could be stated that those costs would endure for some time. Costs may arise in respect of project risks such as delays. These could be significant due to planning and other matters. All such costs would have to be considered in any economic assessment. SPT questions whether the proper application of a test based on the presupposition that a new asset could be procured would yield a cheaper new asset.

*Risks Associated with the Interconnector*

48. The discussion by Ofgem on risks and the methodology for setting a RAV value implies that there will be a reduction in risk if the Interconnector is added to the RAB and that a lower discount rate would be appropriate. As noted above utmost care must be taken in re opening such matters, as there are also factors that suggest that a higher valuation should be ascribed to the licensees' investments.
49. We do not see any reference by Ofgem to the risk profile faced by SP's transmission business when constructing the two upgrades. These risks involved accepting contractual obligations to NGC. By way of example if SPT were delayed, in some circumstances SPT would have to commence the payment of charges to NGC, even though it would have been unable to make any corresponding charge to Users. If construction were stopped NGC would require payment for their costs in some circumstances, and SPT would effectively face sunk costs. Accordingly the risks associated with the contract were high in its early stages and particularly during the construction phases.
50. On the other hand, the upgrade charges are based on a 40-year contract for the first upgrade and 31 years for the second. It was agreed to streamline payments by annuitising all of the costs and revenues at a 10% discount rate over a 40-year period for the first upgrade and a 31-year period for the second upgrade (in line with the 40-year contract). Accordingly, the risks referred to above are recovered over the lifetime of the contract on an annuitised basis.
51. One of the advantages for users paying on an annuitised basis is low payment through the early years on the contract. However the disadvantage from SPT's standpoint is that it defers compensation for the risk associated with this investment until the latter period of the contract period. As only 11 years have elapsed, SPT has therefore not yet been fully compensated for the risk already

taken in respect of its investment. In effect, the risk profile is different from the reward profile and considerable sums are still outstanding to SPT.

52. As a consequence any settlement must take account of the fact that owing to the annuitised nature of charges SPT has not been fully compensated for risks that it has already taken in full in respect of the project.

#### *Pre-Vesting Capacity*

53. We note Ofgem's comment in paragraph 5.54 that SPT and SHETL may not be exposed to the full market risks. It is argued that SPT is not exposed to the full costs of providing the service since transmission users fund the pre-Vesting capacity.
54. This implies that the use of Interconnector capacity may be higher than if the charges for all Interconnector capacity were levied on full commercial terms. We do not believe that this argument is valid. Pre-vesting costs are funded through infrastructure charges payable by all Users including Interconnector Users.
55. SPT is puzzled by the statement that SPT has not borne the full costs of the upgrade capacity. The construction of the upgrade by SPT has resulted in a firming up of pre-upgrade capacity. In effect the funding of upgrade capacity has secured the improvement in the availability of pre-upgrade capacity.

#### *Availability Incentive*

56. Ofgem also refers to the availability incentives in the contracts and argues that it may not be appropriate "to burden transmission users with these out performance arrangements". We do not consider that this incentive changes our position that to date we have not been compensated for our upgrade investments. Again we would reiterate that our requirement is to preserve the value of its revenue stream from the current Interconnector arrangements.

#### *SHETL's Capital Contribution*

57. We note that Ofgem's preferred approach for dealing with SHETL's capital contribution for the upgrade would be to add this contribution to SHETL's RAB. SPT is still considering this matter and its position will depend on the overall settlement for the Interconnector. We accept that this proposal is a pragmatic

solution; however any settlement must include the preservation of revenues that we presently receive from SHETL under the SIA.

### *Constraint Cost Valuation Approach*

58. We are disappointed that Ofgem has rejected the valuation approach based on constraint costs avoided by the GB system operator. Use of constraint costs as a yardstick for the economic viability of transmission projects is a standard approach. Such an approach would represent a proxy for market / economic value as the Interconnector upgrade capacity has facilitated the E&W and Scottish markets since Vesting and, crucially, now allows a GB market to take place. Without the upgrades the GBSO would face significant constraint costs.
59. This leads us to a concern that this approach has been rejected because it results in a high valuation for the Interconnector. If a full review of value is to take place all relevant factors must be considered. The Interconnector upgrades now allow a GB market to take place i.e. without the upgrade capacity there would be no BETTA or a BETTA with significant constraint costs.
60. It should be noted that SPT and SHETL provide data to Ofgem on physical flows and bids to the Balancing Mechanism on both SPT's and SHETL's share of the Interconnector. This data clearly shows that a constraint cost valuation approach would result in a higher valuation of the Interconnector than under other approaches.

### *Interconnector - conclusion*

61. In summary, SPT would reiterate the points that it has made previously to Ofgem, as referred to in paragraph 5.47. In particular we would stress that in setting new price control arrangements Ofgem must ensure that BETTA does not adversely affect the Transmission Licensees' existing commercial interests.
62. To address Ofgem's specific request for views in paragraph 5.53:
- SPT does not support Ofgem's RAV-based proposal that is based on gross MEA, and
  - SPT recommends that its RAB be increased to an appropriate level that preserves the value of SPT's revenue stream from its current Interconnector arrangements.

## **Chapter 6 – Transmission owner incentives**

### *Investment planning*

63. We agree that there is no need for a special investment incentive mechanism under BETTA.

*Outage planning*

64. We support the proposal that the Scottish TOs should receive additional revenue if they incur additional costs as a result of the GBSO changing the agreed Week 49 plan. We accept that TOs should be placed under an obligation to make declarations that reflect reasonable costs that are efficiently incurred.

*Transmission switching and Transmission services*

65. We agree that there is no need to introduce incentive arrangements for transmission switching, in view of the ease with which compliance with the GBSO's directions can be monitored. In the case of transmission services, we agree that it will be sufficient to rely on licence obligations and the STC.

*Liquidated Damages*

66. For new connections, we accept that the liquidated damages terms between the GBSO and users should be reflected in the terms between the GBSO and TOs.

*Gt term*

67. We do not believe that a Gt term is necessarily appropriate for a Scottish TO. In any case, consideration of whether an adjustment mechanism is appropriate should be considered as part of the main transmission price control reviews, as it would be impractical to undertake the necessary analysis prior to the April 2005.