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Dear Andrew

Response to Initial Consultation on Extending the National Grid Company's Transmission Asset Price Control for 2006/07 (102/04)

In this response, we comment in detail on the issues set out for consultation. We believe the issues split into two categories:

- issues regarding extending the components of NGC's existing price control; and
- issues regarding modifying the existing price control to reflect links with other projects.

On the first of these categories, we are in broad agreement with Ofgem's view that a simplified approach in reviewing the price control for the interim period is, wherever possible, appropriate. We believe that further work should take place in respect of capital expenditure, pension and insurance costs.

On the second category of issues, we recognise the linkages to related projects but believe further work over and above that set out in the consultation will be required to modify our existing price control. Most notably, we believe that NGC will require a new top-level control to allow it to recover costs for the GBSO, GBTOs and in particular for pass through of the relevant costs incurred by the Scottish Licensees. This change to the NGC price control will need to be effective from BETTA Go live (April 2005) but, to date, we do not know how the revenue control will work or the process for including these amendments within NGC's licence. We would expect these arrangements to be continued for 2006/7.

Detailed comments regarding the extension of the constituent components of NGC's existing price control

Options for the Review

We agree that a full review for a single year would be disproportionate. We also agree that a simple rollover, as used for the Scottish companies' review of costs for 1999/00, would fail to take into account significant variances between assumptions at the last review and subsequent events for capex and pension costs. Therefore, Option 2, as presented in section 4.2, of a high level review, with certain aspects considered in more detail, would be appropriate.

Operating Expenditure

We believe that the broad approach to extrapolate the operating expenditure assumption for the final year of the current control is the most appropriate basis for the interim control as, otherwise,

the resource associated with a comprehensive operating expenditure review would be disproportionate. However, we believe that specific treatment is required for two categories of cost that are materially different from when the price control was set and over which we have limited control. These are pension costs and insurance costs.

The consultation document discusses incentives for efficiency improvements. The February 2003 update document on developing monopoly price controls considered that it might be appropriate to apply a five-year fixed retention period to NGC's efficiency savings from 1 April 2003. We believe that this is appropriate to ensure consistent sharing of benefits between companies and consumers, irrespective of the timing of savings accruing during a price control period, albeit that, as has been extensively rehearsed in the electricity distribution review, there will be a need to examine the incentives for opex alongside those for capex.

Excluded Revenues

Paragraph 4.25 describes that, in determining NGC's price control revenues, a forecast of excluded revenues is deducted from the total revenues that NGC is permitted to recover, and that revenues in respect of providing excluded services are recovered in addition to price control revenues and NGC bears the risk of any under or over recovery. We recognise that this was the basis used in setting NGC's current price control. However, the modifications to the Transmission licence to facilitate the introduction of 'plugs' effectively removed this risk by the inclusion of the CCC_t term to correct for under/over recovery of excluded revenues.

We believe the appropriate treatment of excluded revenues for the interim review would be to return to the approach used at the original price review. This would involve removing the CCC_t term that facilitated the introduction of 'plugs' and determining a new forecast of excluded revenues reflecting the introduction of plugs and taking into account the review of customer driven line diversion projects which will be part of Ofgem's overall review of capital costs.

Capital Expenditure

We agree with the view in paragraph 4.13 that it would be inappropriate to simply roll-forward the existing price control assumption in respect of capital expenditure. We are already in discussion with Ofgem on the expenditure required for the connection of renewable generation in Scotland and we believe that it is also necessary to review asset replacement and demand related expenditure as expectations of these have changed significantly since the last review.

Valuation of the Asset Base

Paragraph 4.24 states that it would not be proportionate to carry out a full assessment of efficiently incurred capital expenditure for the additional year in the interim review. However it also comments that, in 2005/06, and as part of the next full price control review, Ofgem will review the efficiency of incurred capital expenditure in good time to enable the results to be factored into allowances for the additional year.

We support this approach as we believe that efficient levels of capital expenditure will necessarily exceed allowances in the current control period and, consequently, NGC would be disadvantaged by the deferment of its price review unless adjustment is made to the asset valuation as at 1 April 2006. We also do not believe that it would be in customers' interest to defer remuneration.

A consequence of the proposed approach is that it will not be possible to finalise proposals for 2006/7 until later in 2005/6. In these circumstances, it would be useful if Ofgem published its findings with respect to allowed 2006/07 capital expenditure prior to the final proposals to enable NGC to incorporate Ofgem's findings in the delivery of its capital programme.

We also note that, in calculating the revised asset base for 1 April 2006, it will be necessary to make adjustments for certain repayments associated with the implementation of the 'plugs' charging methodology because they have been capitalised into the RAV.

Cost of Capital

Paragraphs 4.18 to 4.21 consider what cost of capital should be allowed for the additional year. Three issues are raised:

- whether it is appropriate to continue the existing assumption of 6.25%;
- whether it is appropriate that the WACC derived as part of the distribution price control review should be considered for use in extending NGC's price control; and
- whether it is appropriate to continue the differential of 0.25% between NGC and the electricity distribution companies.

We believe that the cost of capital should be informed by DPCR4 discussions, as well as those in the current review of water and sewerage companies. We note that the proposals for DPCR4 are based upon 60% gearing compared to the 50% gearing assumption for the current period which diminishes any justification for the differential between electricity distribution and transmission.

In addition to gearing, in considering the differential between distribution and transmission, the main area to be considered is the relative exposure to unexpected capex. Ofgem's proposals for DPCR4 include the mitigation of DNO risk through the proposed Distributed Generation incentive. The assumed cost of capital for NGC should, in turn, depend upon proposals for dealing with uncertainty in relation to demand and generation related expenditure.

Ofgem has indicated that it would cross-reference the result of the CAPM model with the results of the Dividend Growth Model. At the Ofgem DPCR4 workshop on 20th April, Merrill Lynch presented its view that DGM indicates a cost of capital towards the top of the 6.0 to 7.2% pre-tax range proposed at that time. This view was also supported in a report by NERA on behalf of the ENA. Given the increased difficulty in applying CAPM, and in particular the uncertainty of equity betas, it is currently not clear that Ofgem has given due weight to the DGM approach.

Paragraph 4.22 proposes that Ofgem will use a pre-tax approach to cost of capital for the price control extension and a post-tax approach for the main price review. Current forecasts for the cash tax position of a stand-alone NGC suggest that the tax wedge in 2006/07 will be sufficiently in excess of 30% to justify a post-tax approach in that year.

SO Price Controls

As referred to in paragraphs 4.28 to 4.29, NGC's SO price control in respect of activities in England and Wales will need to be addressed for the additional year. This will include setting allowances for SO internal costs because the last main transmission price review only addressed SO internal costs for the period 2001/2 to 2005/6.

We believe that SO internal operating expenditure allowances can be set with reference to the assumptions made at the last main price review, with adjustments to reflect BETTA, consistent with the proposed approach for setting opex allowances for the TO control.

Allowances for SO internal capex, including Transmission Services Capex will require more detailed review. We support the view in paragraph 4.29 that this should be conducted as part of the work to extend the TO price control as many projects have both TO and SO elements. In

addition, the regulatory asset values assumed in both TO and SO controls will need to be updated to reflect actual SO capex over the current period.

We believe that the current incentive arrangements for Transmission Services Capex should be continued into the additional year. SO Transmission Services Capex is largely driven by changes in the use of the transmission system compared to that forecast at price review. Therefore, investment is less certain and it is more appropriate to share the benefit/cost of under/over-spending with consumers immediately through the sliding scale mechanism rather than just through an ex-post review of the RAV at the next price review.

Links with other projects

Transmission Price controls and BETTA (107/04)

Paragraphs 2.8 to 2.12 discuss the extension of the Scottish price controls to align with NGC's as well as the adjustments to allowed revenues to account for changed responsibilities and inclusion of the Anglo-Scottish interconnector in Regulatory Asset Values. We have submitted our views to the recent consultation separately but, in general, we believe that increased costs for BETTA should be addressed separately and 'bolted-on' to the current NGC price control. For the single year extension, it would appear reasonable to continue to follow this approach, i.e. to roll-over the assumptions for ongoing BETTA-related costs from 2005/6 into 2006/7.

Under BETTA, NGC will require a new top-level price control to allow it to recover the costs for the GBSO and the GBTOs. In particular, NGC's future price controls will need to pass through the relevant costs incurred by the Scottish Licensees as well as the assumed costs of its own business. The new control will need to be effective from April 2005 in advance of the extension to NGC's price control. However, as yet, it is unclear what form it will take or the process for developing it.

Paragraph 2.11 considers how BETTA delay or cancellation costs should be dealt with. We believe that there is no benefit to consumers in deferring the cost of incurred or committed BETTA costs in the event that BETTA is delayed or deferred. Therefore incurred or committed BETTA costs should be included in the NGC price control extension regardless of when and if BETTA proceeds.

Paragraph 2.12 refers to the extension of the SO arrangements under BETTA and that they will be dealt with under the BETTA project. We agree that the extension of NGC's SO activities to Scotland should be addressed under the BETTA project. We would expect that, as above, the additional costs can be added to the current control for 2005/6 and the assumptions will be rolled over for the additional year.

Transmission Investment for Renewable Generation (98/04)

Paragraph 2.4 refers to the recent consultation on the funding of reinforcement's to facilitate the connection of renewable generation. We welcome the recognition that NGC's existing price control does not adequately address the issue of Scottish renewables and the proposal to apply an adjustment to NGC's existing price control to address this. Paragraph 2.6 sets out the three mechanisms being considered:

- a lump sum;
- a revenue driver; and
- pass through

To the extent that a revenue driver or pass through are included in the existing NGC price control, the same assumptions could be continued for the additional year. However, if a lump sum were included, then it would be necessary to assess the likely level of expenditure in the additional year as part of the mini-review.

We believe that, despite the current uncertainty over the extent of future renewable generation, there is a high degree of clarity as to what reinforcements will take place over the period to 2006/7. This is largely because of the limited options for phase 1 of the RETS upgrading and the restrictions upon other work whilst this work is ongoing. Therefore, we believe that a lump sum approach would be most appropriate **in the short term**, with scope for a revenue driver to be developed in conjunction with this as part of the next main transmission price review.

Paragraph 2.4 sets out NGC's estimates of the infrastructure expenditure required over the period 2004/5 to 2006/7. It states that this is NGC's view but that NGC has not committed to this investment. NGC believes that, under the current regulatory framework, such investment is beyond the scope of NGC's licence duties and therefore could be deemed by Ofgem to be inefficient. Were NGC to proceed with this investment, it would be exposed to the risk of non-recovery of this investment. Nonetheless, NGC believes that government policy on renewable energy will not be fulfilled without this investment and it has asked Ofgem for assurance that this investment would be deemed efficient in order for it to proceed.

Ofgem has recently indicated that some preliminary works would be deemed efficient, subject to certain identified criteria. Additionally, it is conducting a joint review of the investment needed to connect renewable generation. We welcome this review and we look forward to the incorporation of its findings into NGC's price controls. However, we remain concerned that the assurances on investment already given are insufficient to enable the coherent development of the system whilst Ofgem reaches its conclusions.

I would be happy to discuss this response further.

Yours sincerely

Tim Tutton