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22 July 2005

Dear Colleague,

**OPEN LETTER ON EXTENDING NATIONAL GRID COMPANY'S TRANSMISSION OWNER
PRICE CONTROL FOR 2006/07**

Introduction

The present transmission asset price control for the National Grid Company (NGC) is due to run until 31 March 2006. In May 2004, Ofgem published an initial consultation paper¹ setting out proposals for extending the price control by one year in order for it to align with price control review dates for other transmission asset owners in both electricity and gas.

Since the publication of the May 2004 consultation document NGC has submitted its responses to the capital expenditure information request. Ofgem has also appointed PB Power to assess NGC's capital expenditure over the period 2000/01 to 2005/06 and NGC's capital expenditure requirement for 2006/07.

This open letter sets out Ofgem's further thoughts on a number of key policy issues for the price control extension. Ofgem would like to hear the views of respondents before developing initial proposals in September 2005.

In setting this one year extension, we have adopted a simplified approach proportionate with undertaking a one year review for NGC. In these circumstances the application of the general principles and conclusion to other price control extensions is likely to be less appropriate than is usually the case when setting price controls substantively where the opportunity exists to consider every component of each price control in detail.

¹ Extending the National Grid Company's Transmission Asset Price Control for 2006/07: Initial Consultation, May 2004 102/04

Key policy issues for the review

In May 2004, Ofgem set out the background and its approach in relation to:

- valuing NGC's regulatory asset base;
- setting NGC's capital expenditure (capex) allowance for 2006/07;
- the appropriate cost of capital; and
- setting NGC's operating expenditure (opex) allowance for 2006/07.

Ofgem has adopted a simplified approach in each of these areas, wherever possible. However, where the evidence suggests that the assumptions underpinning the present price controls are no longer valid or that an alternative approach might be more appropriate then for certain aspects of the review Ofgem has undertaken more detailed analysis.

The value of the asset base

In establishing NGC's allowed revenues for 2006/07, it is necessary to take a view on the Regulatory Asset Value (RAV) upon which NGC will be allowed to recover depreciation and earn a regulated return. If this were a full price control review, this would require a detailed assessment of efficiently incurred capital expenditure during the price control period and updating the RAV accordingly.

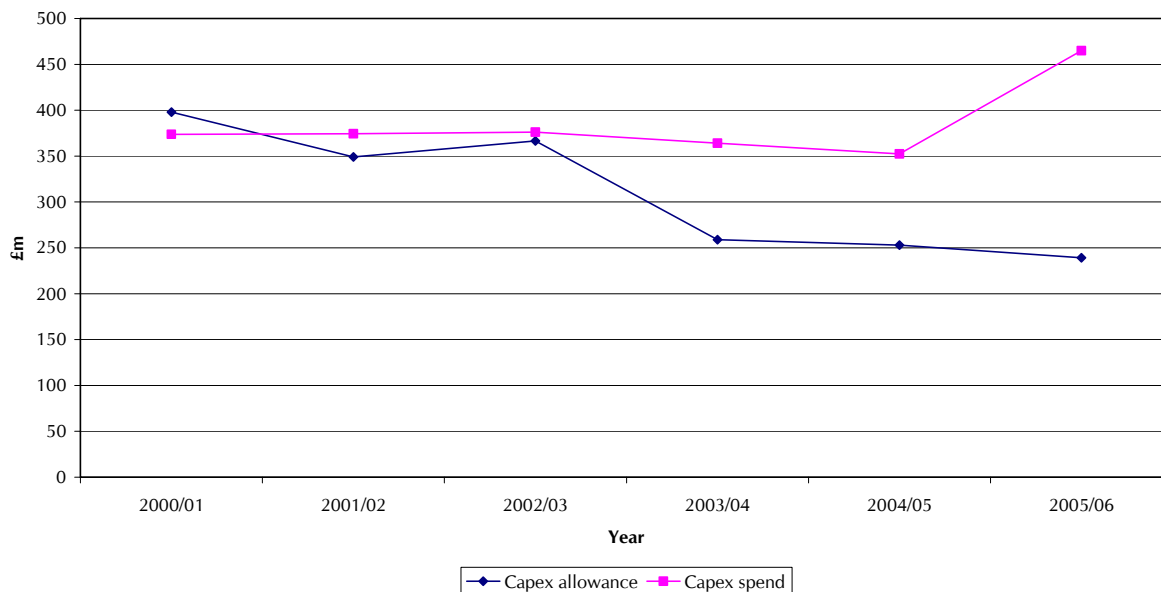
Ofgem has only undertaken a limited review of capital expenditure for the period up to 2004/05 in line with the approach discussed in the initial consultation document. This analysis will be used, where appropriate, to inform the decision on the interim RAV for the purposes of the price control extension. Ofgem intends to undertake a full review of historical capital expenditure as part of the main price control review. Where a full review suggests that a different outcome should have been adopted as part of the price control extension, Ofgem will make adjustments to the price control for 2007/08 onwards to reflect the revised conclusions.

Background

The main issue for the price control extension is the treatment of NGC's large projected capital expenditure overspend in the five year period to March 2006 of £464m in real terms² (£1932m projected expenditure against an adjusted allowance of £1468m) as shown in the chart below. The capital expenditure allowance has been adjusted to reflect the impact of an existing revenue driver in the price control designed to flex allowed expenditure for deviations in generation capacity from central assumptions made at the last price control review.

² all monetary estimates are in 2004/05 prices.

NGC TO Price control - capital expenditure allowances against actual spend



Note:

- 1) 2000/01 represents actual expenditure against allowed expenditure for the final year of the previous price control.
- 2) 2005/06 is projected capital expenditure.

PB Power has undertaken a review of NGC's capital expenditure proposals of Ofgem's behalf. This work includes a broad assessment of NGC's capital expenditure for the period 2000/01 to 2004/05, a detailed assessment of NGC's capital expenditure projections for 2005/06 and 2006/07, and a high level review of asset replacement expenditure for the period 2007/08 to 2011/12. PB Power's assessment of 2005/06 and 2006/07 is set out in Annex A, with further details set out in its report which has been published on the Ofgem website (www.ofgem.gov.uk).³

Ofgem has considered the findings and conclusions of PB Power. This has informed our current thinking that:

- the load related expenditure made by NGC appears broadly reasonable for the period to 2005/06, although there is uncertainty regarding the classification of infrastructure expenditure and the status of some expenditure relating to 2005/06 which has been planned but not committed; and
- there is a wide margin of uncertainty relating to the appropriate level of non load related expenditure and while Ofgem recognises that some or all of NGC's expenditure might be efficiently incurred, we are not confident that we can make a firm judgement in respect of all costs at this time.

³ PB Power Technical evaluation of proposed capital expenditure program for NGC's 2006/07 price control extension, Final report. July 2005

Further detailed analysis would be required to resolve these issues fully. In light of this, Ofgem considers that PB Power's low case scenario for expenditure in 2005/06 (£344.6m) appears to provide a balanced view of expenditure given the extent of the uncertainty set out above. However, further work would be taken forward as part of the main price control review and make adjustments to the 2007/08 price controls where appropriate.

Options for setting the interim RAV

We have identified four options for the purposes of establishing an interim RAV for the price control extension. These are:

1. derive the interim RAV using NGC's reported and projected expenditure over the period 2000/01 to 2005/06, with an adjustment to final year expenditure based on the findings of PB Power in relation to 2005/06;
2. calculate the RAV using the capital expenditure allowances used in setting the present price control taking account of the impact of the existing revenue driver that is part of the current price control;
3. estimate the RAV using NGC's reported actual spend to 2003/04 and revert to the adjusted capital expenditure allowances in respect of 2004/05 onwards given the uncertainties in relation to the capital expenditure projections for the final years of the price control;
4. use a more refined approach to derive the interim RAV by:
 - (a) taking account of NGC's load related capital expenditure incurred in relation to the period to 2004/05 and the allowances for non load related expenditure established in setting the present price control;
 - (b) adopting PB Power's low scenario view of expenditure for 2005/06.

Ofgem recognises that some or all of NGC's capital expenditure overspend might be efficiently incurred. Nevertheless, due to the limited extent of the capital expenditure assessment we are not confident that we can make a firm judgement in respect of all costs at this time. Further detailed work would be required to resolve many of the unresolved issues to determine accurately the appropriate level of non load related expenditure.

In light of the findings of our consultants, Ofgem does not believe that option 1 would strike an appropriate balance of costs and risks between NGC and consumers consistent with its objectives of protecting the interests of consumers and ensuring that NGC is able to finance its activities. Option 2 would provide some protection for customers in relation to costs until a more detailed review of expenditure can be carried out, although it may impose an inappropriate cash flow burden upon NGC in the short term until the outcome of the review is known. Ofgem's initial view is that the burden of option 2 on NGC would be limited.

Option 3 is a simplified approach that provides for some sharing of costs and risks between NGC and customers, recognising that the extent of any uncertainty is lessened in relation to the early years of the price control. In contrast, option 4 provides for a more sophisticated but pragmatic approach to recognise the uncertainty associated with each of the different areas of expenditure based on the work of our consultants.

At present, Ofgem intends to explore options 2 and 4 further and is minded to establish an interim valuation for the regulatory asset base using one of those approaches. All of the above options would be applied with a commitment that, where a full review of past capital expenditure demonstrates that expenditure has been efficiently incurred, the additional funding for depreciation and return that would have otherwise been allowed in 2006/07, would be included as part of the revenue allowances for 2007/08 onwards.

In December 2004, Ofgem set out proposals as part of the extension of the Scottish Transmission price control that assets in relation to the Scottish interconnectors would form part of the RAV from 1 April 2005. Ofgem is committed to implement these proposals as part of this work.

Capital expenditure allowance for 2006/07

NGC has submitted its responses to the capital expenditure information request setting out projected expenditure of £614m in relation to 2006/07. PB Power has examined NGC's capital expenditure programme for 2006/07.

Ofgem and PB Power are both concerned that NGC has not provided sufficient justification for some aspects of the projected increase in its capital expenditure for 2006/07. Ofgem has considered the findings and conclusions of PB Power and these have informed our current thinking that:

- NGC's projected load related expenditure increases significantly in relation to 2006/07, although there is uncertainty regarding the demand and generation assumptions that underpin projected infrastructure investment and the status of expenditure that is planned but not committed;
- there is a wide margin of uncertainty regarding some aspects of non load related expenditure, in particular the driver of substantial asset replacement expenditure.

Furthermore, while PB Power considers that expenditure significantly in excess of the 2005/06 allowance is appropriate, the component parts of their projection are substantially different from those underlying NGC's projection. In particular, PB Power's projections are based on a substantially higher volume of asset replacement work than NGC is planning to undertake. Further work would be needed to understand and/or reconcile the differences, without which it would seem inappropriate simply to adopt either of the monetary estimates.

For the purposes of the price control extension, it is necessary that we establish a capital expenditure allowance. The options are:

- | | |
|----------|--|
| Option 1 | set the allowance using NGC's projected expenditure for 2006/07 (£614.1m); |
| Option 2 | set the allowance based upon PB Power's initial view of the 2006/07 capital expenditure requirement (£521.3m); |
| Option 3 | derive an allowance based on PB Power's low case scenario (£420.6m) |
| Option 4 | set the allowance at the level of NGC's average expenditure over the period 2001/02 to 2005/06 (£386.3m); and |

Option 5 roll forward the allowance in 2005/06 to the extension year (£240m).

Ofgem considers that option 1 is inappropriate as it is not supported by the findings of our consultants. We also recognise that both option 4 and option 5 have the disadvantage of being subjective approaches that are not founded on a robust analysis of NGC's planned capital expenditure programme for 2006/07, although option 4 is consistent with actual expenditure. Nevertheless, Ofgem does not believe that option 2 would necessarily provide an outcome that is in the interests of consumers without further engagement from NGC on the differences in forecasts and more specification of the implied volume of work. In light of this, Ofgem is minded to explore options 3 and 4 further.

In relation to the approach set out above, Ofgem is mindful of the balance of incentives that created by each of these options. In light of this, further work is planned to consider whether the options provide strong incentives for investment deferral. Ofgem considers that it might be appropriate to incorporate a mechanism to pass on the benefits of a capital expenditure underspend to users of the transmission system. This may take the form of a mechanism applied to all capital expenditure or focus on particular areas of expenditure, for example exit related expenditure.

Cost of capital

In establishing the NGC's allowed revenues for 2006/07, it is necessary to take a view on the appropriate allowed rate of return. The present transmission asset price control allows a real pre-tax rate of return of 6.25 per cent. The initial consultation indicated that it would be appropriate to review the suitability of the assumptions with respect to the cost of debt and equity finance and the level of gearing.

In November 2004, Ofgem's final proposals for the electricity distribution price control review⁴ set out Ofgem's proposals regarding the allowed cost of capital for the electricity distribution companies. The final proposals established a post-tax cost of capital of 4.8 per cent. This assessment was based on a post-tax real cost of equity of 7.5%, a pre-tax cost of debt of 4.1% and an assumed gearing level of 57.5%.

Ofgem has historically provided for tax liabilities through an allowance in its estimate of the pre-tax cost of capital. However, in the recent electricity distribution price control review Ofgem used a post-tax approach to the cost of capital and calculated the required tax allowances separately for each of the DNOs. One reason for this approach was to reflect the change in the Inland Revenue's treatment of network capital expenditure, which is expected to increase the effective tax rate for most network companies.

The allowed post-tax return for the DNOs is equivalent to a pre-tax cost of capital of 6.9 per cent calculated on the traditional basis using a 30 per cent tax wedge. Including the actual allowances for tax, the effective pre-tax cost of capital for the DNOs varied between the individual companies but was, on average, about 8%.

⁴ Electricity Distribution Price Control Review: Final Proposals, November 2004, 265/04 p. 102-109

Ofgem considers that the approach to setting the cost of capital used in the electricity distribution price control review is broadly applicable for the purposes of extending the NGC price control, given the similarities between the electricity distribution and transmission businesses and the timing of the review.

The main issues for the price control extension are therefore the extent to which any difference of approach would be applicable to NGC (such as, for instance, in the assumed gearing rate) and the appropriate treatment of tax. We have therefore identified the following options:

- Option 1 adopts the underlying outcome of the recent distribution price control review with a simple conversion for tax allowances for the interim period. One possibility would be to assume the standard 30 per cent tax rate; or
- Option 2 derive a value for the cost of capital based on the common components of the DPCR conclusion, but taking a view of specific risks and tax liabilities pertaining to NGC.

Option 2 would reflect Ofgem latest view on the appropriate returns to debt and equity, but also recognise a specific view of risk profile and gearing specific to NGC. Nevertheless, it may not be proportionate to undertake a large amount of work to determine specific tax liabilities. In light of this, Ofgem is minded to develop initial proposals based upon option 2 with a high level review of the tax position of NGC.

Operating expenditure

The initial consultation document noted that NGC's cumulative performance in managing operating expenditure was broadly in line with the assumptions made in setting the present transmission owner price control. In light of this, Ofgem proposes to carry forward the 2005/06 allowance for controllable operating expenditure adjusted for inflation. It is for consideration whether the 2005/06 allowance should be adjusted to reflect further potential efficiency savings.

Ofgem has noted specific requests that pension costs and insurance costs should be given specific treatment as part of the 2006/07 price control. While Ofgem recognises that there are specific issues relating to the treatment of pension costs and insurance, consideration of these will be deferred until the main price control review. Ofgem will make any adjustments necessary to the price control for 2007/08 onwards to reflect the outcome of this work.

Next steps

The timetable for the remainder of the project is tight and further detailed work and consultation may be required to develop Ofgem's proposals later in the year. To ensure that further work and the views of stakeholders can be reflected in our proposals in a timely way we have reduced the consultation period for this document and the initial proposals from six weeks to four weeks. In light of this, Ofgem the timetable for the project is as follows:

Date	Output milestone
July 2005	◆ Open letter published (with four week consultation)
Sept 2005	◆ Initial proposals published (with four week consultation)
October 2005	◆ Responses to the initial proposals received.
November 2005	◆ Final Proposals published.
January 2006	◆ Licence modification – statutory consultation

Responding to this document

Views are invited in relation to any aspect of the issues sets out in this letter. Responses should be received by 19 August 2005 and should be sent to:

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London
SW1P 3GE

Email: TPCRresponses@ofgem.gov.uk
Tel: 020 7901 7143

Unless marked confidential all responses will be published by placing them in Ofgem's library or on the website. It would be helpful if responses could be submitted both electronically and in writing. Any questions on this document should, in the first instance, be directed to Colin Green, who can be contacted on 020 79017143 or by email at colin.green@ofgem.gov.uk.

Yours sincerely

Robert Hull
Director – Transmission

ANNEX A – PB POWER’S VIEW OF THE POTENTIAL RANGE OF EXPENDITURE IN 2005/06 AND 2006/07

Categories (2004 prices)	5 year average (£m)	2005/06				2006/07			
		NGC projection (£m)	PB Power view (£m)	PB Low scenario (£m)	PB High scenario (£m)	NGC projection (£m)	PB Power view (£m)	PB Low scenario (£m)	PB High scenario (£m)
LOAD RELATED EXPENDITURE									
Entry	10.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Supergrid system extension (infrastructure)excl TSS	112.4	124.8	101.0	101.0	124.8	174.6	153.4	115.1	174.6
TSS	8.8	0.6	0.6	0.6	0.6	0.0	0.0	0.0	0.0
Exit	64.5	87.1	74.0	64.5	87.1	101.4	76.0	64.5	101.4
GT Factor									
Abatements		-10.0	-10.0	-10.0	-10.0	0.0	0.0	0.0	0.0
Total Load Related	193.9	202.5	165.6	156.1	202.5	276.0	229.4	179.6	276.0
NON-LOAD RELATED EXPENDITURE									
Asset Replacement:									
Transformers	6.6	13.8	13.2	10.6	13.2	19.5	19.5	15.6	19.5
Switchgear	19.0	27.2	25.9	20.7	25.9	35.8	35.8	28.6	35.8
Sub-station other	7.6	9.5	9.1	7.3	9.1	16.9	16.9	13.5	16.9
Overhead Lines	41.6	125.1	83.8	67.0	83.8	140.8	94.6	75.7	94.6
Underground Cables	25.1	31.8	30.3	24.2	30.3	55.2	55.2	44.2	55.2
Protection									
Telecontrol / SCADA / Energy Mgt									
Protection & Control	32.5	30.3	28.9	23.1	28.9	32.7	32.7	26.2	32.7
Abatements		-11.0	0.0		0.0	0.0	0.0		0.0
Diversions: non-rechargeable									
Other TO	38.2	35.3	35.3	35.3	35.3	37.3	37.3	37.3	37.3
SO excl BETTA	14.4	12.1	12.1	12.1	12.1	14.0	14.0	14.0	14.0
Total Non-Load Related	184.9	274.1	238.6	200.4	238.6	352.2	306.0	255.1	306.0
Customer Contributions (enter as negative)	-10.8	-11.8	-11.8	-11.8	-11.8	-14.1	-14.1	-14.1	-14.1
TOTAL CAPITAL EXPENDITURE	368.1	464.8	392.4	344.6	429.3	614.1	521.3	420.6	567.9

Note: Five-year average spend is the average for the period 2000/01 to 2004/05.