NATIONAL GRID COMPANY plc[1]

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

Introduction

1 We welcome the opportunity to comment upon Ofgem's further thoughts on key policy issues for extending National Grid Company's Transmission Owner Price Control for 2006/07.

2 We have serious concerns about Ofgem's initial views with respect to the costs which we have incurred, and will incur, both during the current price control period (2000/01 to 2005/06) and during 2006/07. We do not believe that these proposals are in consumers' interests and we consider that the proposals would not provide adequate funding for us to meet our licence obligations. This response addresses the key areas of our concern and provides additional evidence and analysis in support of our response where this is required.

Areas of concern

3 Our key areas of concern in this response, considered under four main sub-headings, are as follows:

(a) re-set of Regulatory Asset Value (RAV);

(b) capex allowance for 2005/06 and 2006/07;

(c) cost of Capital;

(d) opex allowance for 2006/07; and

(e) the general principle of both the NPV-neutrality and cash-neutrality of delaying the start of the next main NGC price control until April 2007.

Re-set of regulatory asset value

4 Ofgem identify four options for the purposes of establishing an interim RAV for the price control extension. Ofgem state they intend to explore Options 2 and 4 further to establish an interim valuation. Option 2 would take no account of NGC's actual expenditure in the current price control period, whilst Option 4 would take into account NGC's actual load related expenditure through to 2004/05, and PB Power's Low scenario for 2005/06 expenditure.

5 **We believe that the 1 April 2006 interim RAV should be set on the basis of NGC's reported and projected capex in the period**, with the understanding that this will be reviewed as part of the main transmission price review. Adjustment would then

[1] On July 27 National Grid Company plc changed its name to National Grid Electricity Transmission plc. All references in this document to National Grid Company plc (NGC) refer to the entity now named National Grid Electricity Transmission plc.

be made such that the NPV of revenue over the whole six year period through to 2011/12 becomes consistent with the analysis concluded with agreed final proposals.

6 In support of our view, we welcome PB Power's high level assessment that they "found no evidence to conclude that NGC's capital expenditure was not needed or inefficiently incurred" in the period up to and including 2004/05. With such an assessment from Ofgem's appointed consultants, we believe the case to include this expenditure in the interim RAV is compelling.

7 We note Ofgem's intention to carry out further assessment of historic expenditure but, in the event that this further assessment suggests that any historic expenditure should not enter the RAV, appropriate adjustment should be made in the main price control review.

8 Ofgem state their initial view that the cashflow burden on NGC of pursuing Option 2 would be limited. We strongly disagree with this position for two reasons. First, for the reasons developed further in paras 20 and 21 below, we believe that there should be **no** cashflow burden simply by virtue of the price control extension itself. Second, the burden that would be placed on NGC is significant. The loss of cashflow in the year would be in the order of £50m, representing approximately 5% of the revenue in the year.

Capex allowance for 2005/06 and 2006/07

9 Ofgem state that PB Power's Low scenario for 2005/06 (£344.6m) appears to be appropriate. Ofgem also identify five options for the purposes of establishing a capex allowance for 2006/07. Ofgem state that they intend to explore Options 3 and 4 further. Option 3 would derive an allowance based on PB Power's low case scenario (£416.9m), whilst Option 4 would set the allowance at the level of NGC's average expenditure over the period 2001/02 to 2005/06 (£386.3m).

10 **We believe that our forecast of £464.8m in 2005/06, and £614.1m in 2006/07 remains the balanced view of the correct level of expenditure, consistent with our reasonable expectations regarding the development of the electricity transmission system, our licence obligations and the resources that are available**. Our reasons for this position are that:

(a) The usual arguments about uncertainty, especially in relation to load-related expenditure, which have a deal of force over a normal main price control period, have less relevance to a mini review period whose end is around only 19 months away.

(b) We are extremely concerned that Ofgem, having asked PB Power for independent advice, are considering rejecting PB Power's View in favour of either a Low Scenario which is implausible (for the reasons given in the attached appendix) or an allowance based on historical expenditure, at a time when the major factors driving higher expenditure have been largely accepted by PB Power.

(c) In respect of the findings of PB Power as set out in the report titled 'Technical Evaluation of Proposed Capital Expenditure Program for NGC's 2006/07 Price Control Extension', we have a large number of comments which are detailed in the attached appendix. However, of these comments, five of our most significant concerns are summarised below:

(i) that the report does not recognise the detailed condition-based information on **specific** assets that drives the need case for our asset replacement in this period (this at the same time that Ofgem continually assert the need for replacement capex to be based on condition of assets);

(ii) the omission of an allowance for a major category of overhead lines expenditure ('fittings-only' schemes) which is essential to the delivery of the most economic solution of managing overhead line assets;

(iii) the unjustified reductions made to load-related expenditure in respect of generation, exit and reactive compensation schemes;

(iv) the inadequate appraisal of the resources available to NGC to manage and engineer the forecast levels of capex. This does not recognise the full range of resources available to NGC and the advanced plans that are in place within NGC and its suppliers to deliver the programme. This appraisal is then used as a basis to create the implausible Low scenario; and

(v) the flaws in the both the Low and High scenarios, of which Ofgem use the Low scenario to inform their view on the allowance for NGC for 2006/07.

11 A complete analysis of these comments is detailed in the appendix to this response. We believe that each of these significant concerns must be addressed in order for Ofgem to determine the appropriate allowances for capital expenditure that is consistent with NGC operating within its licence obligations and look forward to discussing these issues with Ofgem and PB Power.

Cost of capital

12 Ofgem identify two options for establishing a cost of capital for the purposes of setting allowed revenues for 2006/07. Ofgem state they intend to develop Option 2 with a high level review of the tax position of NGC. Option 2 would derive a value for the cost of capital based on the common components of the Distribution Price Control Review (DPCR) conclusion, but taking a view of specific risks and tax liabilities pertaining to NGC.

13 In the circumstances of doing a one year price control extension, we accept that it is not practical for Ofgem to carry out a complete assessment of the cost of capital for NGC. Thus, in the absence of a complete assessment, we believe the only appropriate methodology would be to read across the comprehensive DPCR analysis, taking into account at a high level the tax position of NGC.

14 In support of this read-across treatment, we note the recent regulatory precedents that applied this treatment to both the extension of the Scottish Transmission companies' price controls and the Transmission Investment for Renewable Generation (TIRG).

15 In respect of the consideration of the specific risk profile of NGC, we believe its risk profile is at least equivalent to the risk profile of the Distribution Network Operators (DNOs) considered in the DPCR, not least because of:

(a) the size of NGC's investment programme relative to its RAB; and

(b) NGC's lower rate of regulatory depreciation which, by itself, implies a lower cashflow per £ of RAB (and therefore a commensurately bigger shareholder exposure over a longer period of time).

Opex allowance for 2006/07

16 Ofgem propose to carry forward the 2005/06 allowance for controllable operating expenditure adjusted for inflation.

17 In the circumstances of doing a one year price control extension, we accept that it is not practical for Ofgem to carry out a complete assessment of the controllable operating expenditure for NGC. Thus, in the absence of a complete assessment, we agree that Ofgem's proposed approach to carry forward the 2005/06 allowance adjusted for inflation is appropriate.

18 Ofgem have recognised that there are specific issues relating to the treatment of pension costs and insurance in respect of determining the appropriate opex allowance for 2006/07. Ofgem describe an intention to make adjustments in the main price control review to reflect the outcome of main price review work in these topics. We support this view but note that we can only be held NPV neutral by this approach if Ofgem specifically define the pensions and insurance assumptions that underlie the 2006/07 revenue assumptions. We therefore look forward to working with Ofgem to determine these specific allowances.

Cash and NPV neutrality of delaying the main NGC price review

19 As noted above, we accept that issues like pensions and insurance can only be effectively dealt with as part of the main price review. In respect of these issues, we would therefore look to the outcome of the main price review being NPV neutral, in the sense that the final review outcome would be appropriately uplifted to allow for the delay in remunerating costs incurred in 2006/07.

20 However, in general, we do not think that NGC should suffer **either** a NPV hit **or** a cash hit simply by virtue of the main price review being delayed by a year. Therefore, where there is an uncertainty about the level of efficient costs which will be incurred in the mini review period – and this uncertainty will be resolved or diminished during the main price review – it is our view that the best estimate of costs to be incurred in the mini review period should inform the mini price review outcome, rather than simply leaving the issue to be resolved as part of the main price review.

21 This consideration particularly reinforces our view that the RAB re-set for April 2006 should be based on best available information, rather than on the sort of arbitrary assumptions currently being suggested by Ofgem. In our view the best available information is what we have actually spent, combined with PB Power's view that there is no evidence to suggest that the expenditure was not needed or inefficiently incurred. On this basis, the presumption must be towards reflecting actually incurred spend in the RAB – and this should be the outcome of the mini review (albeit that Ofgem may want to undertake further analysis of the relevant spend as part of the main review). Anything other than this outcome would be to seriously undermine both NGC's and any other energy network's confidence in responding to customer demand and their own licence obligations, especially when this requires spending more than an amount of money which has been estimated on the basis of (inevitably) outdated information.