

Inveralmond House  
200 Dunkeld Road  
Perth PH1 3AQ

Colin Green  
Senior Manager NGC price control extension project  
Office of Gas and Electricity Markets  
9 Millbank  
London  
SW1P 3GE

Tel: 01738 456400  
Fax: 01738 456415

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Dear Colin,

### **Extending National Grid's TO Price Control for 2006/7**

I am writing in response to Ofgem's open letter of 22 July 2005 regarding extending National Grid's TO Price Control for 2006/7.

The letter invited views on three main areas of work; capital expenditure; cost of capital; and operating expenditure. Our views on these and other issues are set out below.

### **Capital Expenditure**

In respect of the historic overspend in 2003/4 and 2004/5 we agree that efficiently incurred expenditure should be allowed on the regulated asset base. In this respect we support Ofgem's commitment in this open letter that "where a full review of past capital expenditure demonstrates that expenditure has been efficiently incurred, the additional funding... would be included as part of the revenue allowances for 2007/8 onwards".

To that end, we believe there would be merit in terms of reducing regulatory uncertainty in reaching an early agreement on the historic RAV. We also note that there is still six months between now and the deadline for bringing forward licence modifications for the one-year extension. We would therefore recommend that Ofgem's initial focus should be on a detailed assessment on NGET's actual spend up to 2004/05 (with the use of consultants) with a view to finalising the RAV at 31<sup>st</sup>

March 2005 as part of this "mini-review". This would leave only the 2005/06 and 06/07 forecasts as requiring resolution for the mini review.

If this approach is not possible, we believe the work of Ofgem's consultants in the main review should be prioritised so that the review of past capital expenditure is dealt with early on in the process. This would provide early certainty of the initial asset values for the main price control review.

In terms of the main review, load-related expenditure is a particular concern. The current initiatives by Government to move towards a low carbon economy have resulted in an unprecedented number of applications from renewable generators for connection to the system not only of NGET, but also of the two Scottish licensees. While it is unlikely that all of these projects will succeed in obtaining the necessary consents, significant investment will still be required to accommodate the successful projects.

While the necessary investment can be identified and linked to the generation projects, the total level of investment and its timing is dependent on the progress of these projects. NGET's previous five-year price control had a forecast level of load related expenditure with an incentive term (the Gt term) to set an incremental allowance dependent on the volume of new generation connecting. In our view, this is too blunt an instrument for setting an incremental adjustment to allowed revenue. In contrast, the two-year extension to the Scottish licensees' price control had a new allowance for transmission investment for renewable generation (the TIRG term) for named major projects driven by renewable generation.

We believe that this more sophisticated approach of linking allowed revenues to the actual construction programme for major projects is a significant step forward in dealing with uncertainty and should be further developed for the main review.

### **Cost of Capital**

We agree that the cost of capital for the mini review should be based on the same post tax figure of 4.8% determined for the distribution price control review and for the Scottish transmission licensees' 2-year extension. This would allow a more detailed assessment of the cost of capital at the main review.

We also agree that for a one-year extension it would be disproportionate to undertake a large amount of work to determine specific tax liabilities. The initial proposals should therefore be based on a high-level review of the tax position of NGET, as was done for the Scottish companies.

## **Operating Expenditure**

We agree that for the one-year extension, it is appropriate for Ofgem to carry forward the 2005/6 allowance for operating expenditure in the interest of preserving incentives for efficient operation.

I hope these comments are helpful and if you require any further information, please give me a call.

Yours sincerely,



Rob McDonald  
Director of Regulation

