Transmission Price Control Review – Initial Consultation
Response by Association of Electricity Producers

08 September 2005

Introduction The Association welcomes the opportunity to contribute to the development of the 2007 Price Control Review and applauds Ofgem's early involvement of the industry. The Association of Electricity Producers (AEP) is the UK trade association representing electricity generators. It has some 100 members ranging from small firms to large, well-known PLCs. Between them they embrace nearly every generating technology used in the UK. Many member companies have interests in the production and development of renewable energy where the government has set ambitious targets for development over the next decades.

Our response to the consultation document follows the layout of the questions posed within the document. The question is posed in italics and our response in normal font.

Chapter 4 - Framework, content and objectives
♦ *How should Ofgem seek to address the external factors cited in paragraph 4.11 above in setting new price controls? Are there any other external factors that Ofgem should take into account?*

- The closer linkage between gas and electricity networks is only likely to become more important as the proportion of gas-fired generation rises. This will have impacts on both investment and operation of the networks. The current mechanisms for connection and investment in infrastructure should be robust to this development, as it is effectively 'more of the same'. Operational incentives may need further development.
- The growth of distributed generation poses a challenge to ensure that the price controls do not result in perverse incentives for generation to connect at locations and voltages that would not be the 'natural' technical/commercial choice. Ofgem will need to bear this risk in mind whilst developing the price controls.
- The impact of carbon trading is primarily an issue for generators. The greatest risk posed arises from uncertainty about the long-term governmental and regulatory approaches to carbon trading and other environmental legislation, not from the price control.
- Generators will be looking for demonstration by Ofgem that the SO cash-collector role for TOs is performed at minimum additional costs to users.
- Where the impact of the external factors is well understood and predictable with some degree of confidence then they could be factored into the price control otherwise they will need to be managed on an exceptional basis.
- Changing gas quality might be an area that has an impact on NGT in the next price control period but as yet its impact is not predictable and whilst it could be recognised in consultation documents it would be difficult to explicitly take this into account in the price control.

♦ *Is the standard model of a five year control and RPI indexation still appropriate for the next transmission price controls? Are there any areas of activity which should be price-regulated differently, including any scope for de-regulation?*

- We have not yet seen a convincing argument for abandoning the basic 5-year control period with an RPI-X indexation. We see a continuing role for the various refinements to the RPI-X model identified in Para 4.30 onwards.
- De-regulation should be an option where there is a realistic probability of market-based competitive alternative to the current methodology. As this price control covers core business for the monopolies we do not see scope for significant de-regulation.

♦ *What particular areas of the licensees' activities should Ofgem focus on in this price control review?*

There are a number of novel areas, or areas of significant change that Ofgem will need to focus on in their review.

- The integration of operational control of the transmission networks under BETTA provides an opportunity for NGC as SO to derive benefits of scale. These should be reflected in the SO Incentive scheme. Ofgem will have the opportunity to develop a longer term approach to an SO Incentive under this review. This approach will need to be sufficiently flexible to cope with change in the electricity market. Connected parties will wish to be fully involved in this area. It should be noted that in recent SO Incentive scheme discussions NGC have admitted that they saw little scope for further innovation in SO incentive schemes. SO Incentive schemes have now reached maturity and we see no continuing need for high sharing factors for NGC. Given that the purpose of the incentive is to incentivise NGC management, not their shareholders, the sharing factors for incentive schemes should reflect this requirement and be slim.
- The growth of offshore renewable generation and its connection to the main GB grid is an area in which new investment and operational issues will arise. Careful focus will be required to ensure the structure of the price review deals with this issue area over the next 5 years and beyond.
- NGC have indicated a substantial increase in the level of replacement capital expenditure (paragraph 5.6 refers). Association members would expect to see close scrutiny and justification of this approach. International benchmarking may help here.
- The concurrent assessment of TO and SO should allow Ofgem to consider the issue of how reactive compensation equipment should be rewarded. At the moment it is rewarded as an asset of the TO and as part of the SO Incentive scheme. We would suggest this area needs to be ring-fenced and subjected to some form of market testing against alternative sources of reactive response.
- The introduction of the Electricity Transmission Capacity Incentive for NGC was clearly in response to the fuss raised following the London blackout. The Association argued at the time that if the intention was to encourage provision of relevant network access to minimise disruption to domestic consumers, then an incentive focussed on distribution network performance would be far more cost effective. This review should give Ofgem an opportunity to quietly drop this transmission incentive and consider its replacement with a distribution network incentive, if one is needed at all.
- Association members are concerned that in seeking to achieve ever more subtle levels of incentivisation, there is a risk that NGC will be incentivised to create situations in which various incentives are maximised whilst the complexity of the incentives leads to an inability for their actions to be adequately audited.

♦ *Should incentives to reduce costs be strengthened or weakened?*

- Incentives have typically comprised two components: caps and collars, and sharing factors. The maturity of the relevant schemes suggests that the sharing factors can be made slimmer, particularly considering that past performance has routinely produced near maximum gain for NGC. The size of caps and collars will depend on

the best assessment of the likely costs going forward and will necessarily require scenario assessment, probably on an annual cycle.

♦ *How should the range of refinements to the basic RPI-X form of control be deployed by Ofgem in setting the next transmission price controls? Are there any refinements that should be used more or less than is currently the case?*

- Ofgem recognise the scope for greater use of rolling incentives (paragraph 4.42 onwards). The review gives a good opportunity to produce robust proposals in this area.

♦ *Are rolling incentives appropriate for transmission and if so how long should the retention periods be for efficiency savings? Should the rolling incentive approach adopted in gas for incremental entry capacity also be adopted in electricity?*

- Rolling incentives are appropriate to avoid licensees delaying investment towards the end of the period into the next to achieve incentive benefits

♦ *Should Ofgem seek to ensure that the strength of incentives for efficiency in operating costs and capital expenditure is equalised?*

- In principle yes, so that there is no incentive to 'manage' revenues into the most appropriate category given the incentive arrangements. Ofgem would need to ensure that this does not give rise to other unintended consequences. For example, in a network that may be subject to constraints, the decision between increased investment and increased BSUoS needs to be set up so that NGC would come to an economically rational answer, consistent with the requirements of the market.

♦ *Are Ofgem's objectives for the price control review appropriate and comprehensive? If not, how should the objectives be re-stated?*

- The objectives are appropriate, but we suggest that Ofgem should also consider how the complexity of price controls and incentives could be reduced. This is particularly relevant to gas where the existing TO and SO controls in relation to entry are so complex that they are extremely difficult to understand even for industry participants.

Chapter 5 –Assessing costs

♦ *What might an increasing importance of non-load related capital expenditure (as opposed to load related capital expenditure) mean for how Ofgem undertakes the price control review?*

- Investment may not manifest itself in terms of additional capacity, but rather enhanced resilience to changing supply / demand patterns. This is important but it may be more difficult to assess if this has been undertaken efficiently.

♦ *How, if at all, should Ofgem adapt its approach to assessing capital expenditure requirements related to growth in renewable and distributed generation and future plant closure?*

- A scenario-based approach should allow Ofgem to test the robustness of their models to a variety of major changes that can be anticipated with some degree of certainty.

♦ *Does the model of assessment adopted for TIRG provide a useful model for the price control review?*

- The "TIRG" model may form a useful basis for funding uncertain levels of investment. Its basic principles mean that an economic investment project is identified and linked to a trigger level of activity (in this case the level of renewable generation wishing to connect). When the trigger point is reached then the licensee can proceed with certainty of the funding, and an incentive on efficient delivery of the output capacity. The market can therefore be confident that the investment is economic in the circumstances. We believe this mechanism should be considered for further developed for the price control.

Operating costs:

♦ *What particular areas of operating costs should Ofgem focus on in its assessment of the current and future efficiency of the transmission licensees?*

- The Association agrees with the broad scope as defined in the consultation document.

♦ *What approaches, other than those identified in this chapter, might be available to Ofgem in assessing the efficiency of each transmission licensee's operating costs?*

- Ofgem draw attention to the difficulties of benchmarking across the companies. We suggest two other aspects should be considered: firstly, the opportunity for international benchmarking and secondly, the opportunity for benchmarking across different industry sectors by activity. Although the type of benchmarking carried out in the DPCR would be inconclusive because of the small sample, there are other examples (most recently NERA's report for Ofcom on the efficiency of BT) where international benchmarking using a range of techniques can be used to determine if there are any consistent "front runners" in efficiency. We believe such techniques could usefully be used here

Cost reporting:

♦ *What form of cost reporting framework should Ofgem develop for each of the transmission licensees as a means of monitoring performance under the new price controls over time?*

- Capital expenditure and operational activity need to be reported in differing timescales. Operational activity can have impacts on the market in the short term whilst investment timescales are typically annual and longer. NGC have shown commendable enthusiasm for enhanced transparency of information under their REMI initiative. The Association applauds this.

Chapter 6 – Incentives

♦ *How should Ofgem encourage users and potential users of the system to signal their future requirements and how should the licensees be incentivised to meet these requirements?*

- For gas transmission system exit capacity we consider that the existing arrangements for securing incremental capacity work well for direct connects and we welcome proposals to extend these to DN offtakes. We believe the entry auction mechanisms in gas have not been a great success. They do not seem to have provided any superior investment signal over and above that realised via the investment planning/Ten Year Statement/TBE process. The main change is that shippers get a firm financial commitment by Transco NTS to an entry capacity product, which may or may not be underpinned by a physical asset. This is aptly illustrated by the recent urgent modifications raised by Transco NTS to "fix" yet more problems and the churn of costs between gas shippers. We definitely do not want to see the entry regime replicated at exit. It is also exacerbated by the complex price control incentives regime which is extremely difficult to understand.

- Over the next year or two, the industry will learn how well the method currently being implemented by NGC to deal with the queue of connection applications will operate. Based on this the method may need refinement. In contrast to the entry auction system, the mechanism in electricity for applicants to "underwrite" and capacity enhancements coupled with their obligation to pay TNUOS once connected seems to be a reasonably robust means to "signal" capacity requirements. This is similar to the ARCA approach adopted at gas exit.

♦ *Is there a need for consistency between gas and electricity transmission and between arrangements for entry to and exit from the networks?*

- There is no fundamental reason why the arrangements on both networks or at entry and exit on any network should be the same so long as the arrangements meet the needs of network users and customers in an efficient manner. Appropriate arrangements will need to consider the number of users / degree of competition at a particular point and whether the interaction of incentives and baselines could lead to any unintended consequences. Compliance with EU legislation will also need to be considered.

♦ *To what extent should new users of the networks be required to make a firm financial commitment before the Transmission licensee is required to make capacity available to them?*

- A new connection or significant increase in capacity at an existing connection will usually be linked with substantial capital expenditure on a customer's plant or in the case of networks investment in the network to carry the additional demand. The financing of this investment may require assurances that the capacity will be available in timescales compatible with the project. Standard ARCA type agreements are well suited to this purpose, as they can be tailored to the incremental capacity required and lead time of the project.

♦ *How should baseline outputs and incremental outputs be defined for (a) electricity transmission licensees, and (b) Transco NTS? Should the existing definitions be retained? If not, how should they change?*

- The Association considers that the baselines outputs and incentives for provision of incremental capacity should be set in a manner consistent with the prevailing commercial arrangements for securing capacity. Whilst also taking full account of the interactions and consequences of a particular set of arrangements to ensure the regime provides the appropriate incentives on all parties; licensees and network

users. We therefore consider that the commercial arrangements should be considered preferably before but at least alongside this baseline and incentive issues which should not be considered in isolation.

We are therefore only able to make very general comments on the options for baselines:

- The options for determining baseline levels do not need to be the same for gas and electricity networks nor for entry and exit of the same network. The option should be appropriate to the particular circumstances.
- baseline outputs that are inconsistent with the level of investment on a constrained basis may increase buyback costs or require licences to invest in capacity that does not give rise to incentive revenues
- There is also a need also to ensure that baselines reflect what is physically available and not just what has been "booked" otherwise parties might end up paying for something via the SO incentive that actually already exists and the incentive would become a source of windfall profit for the regulated monopoly.
- baselines need very careful consideration at this price control review given the recent Transco NTS UNC modification proposals to effectively modify licence obligations by not making capacity available or delaying when it will be available.
- Baselines should be set on a nodal or zonal or national basis, consistent with the product being sold and in a manner that does not have an adverse impact on connectees' commercial interests.

♦ *How should the provision of incremental outputs be remunerated? Should NGC have a similar incentive to Transco NTS in respect of incremental capacity, i.e. that it is rewarded for providing future capacity based on firm commitments by network users to pay?*

- NGC currently provide incremental access to the transmission network via the STTEC process. To date the product offering has not proved popular, but this may change. The provision is based on a cost-reflective application fee and the price paid for the access being factored into the TNUoS pot. NGC's activity in assessing and managing STTEC is seen as a marginal addition to their normal operational planning. For so long as the STTEC product provides marginal additional access, this approach should be continued. (It should be noted that there is not unanimity regarding the level of price for this access product amongst generators). The addition of an incentive to NGC to do what is a licence obligation seems unnecessary and potentially counter-productive. There could be a perverse interaction with NGC's SO Incentive. There also seems to be scope for unintended interaction with the transmission network access availability incentive established following the London blackout.

- Regarding the provision of long-term access, it is not clear why any incentive mechanism is needed to get NGC to perform their licence obligation. If they fail, the regulator has powers to enforce compliance and penalise shortcomings. Additionally, the reputational damage of such actions should not be underestimated.

♦ *To what extent should Ofgem set price controls in the expectation that they will need to be re-opened in the light of future events, or should Ofgem as far as practicable seek to set price controls which adjust revenues automatically as circumstances change?*

- The Association recognises the changing nature of the networks in response to changing supply/demand patterns in both gas and electricity and agrees that there may be benefits in capturing this in some manner in the price control. However the price controls are supposed to provide licensees and network users with a degree of stability within the period, so that re-openers should only be used in limited

circumstances where benefits to both parties will be evident and with a test that the re-opening event could not reasonably have been foreseen. The use of revenue drivers may also be appropriate in so far as they do not introduce undue complexity.

Chapter 7 – Financial Issues

♦ *What are the reasons why the cost of capital for a transmission business might be different to the cost of capital for a distribution business?*

- Apart from the normal features of any business that might impact on the cost of capital we are not aware of any differences.