

Robert Hull  
Director, Transmission  
Ofgem  
9 Millbank  
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September 2005

Dear Mr Hull

**Re: Transmission Price Control Review – Initial consultation.**

energywatch welcomes the opportunity to respond to Ofgem's consultation document. energywatch has elected not to respond specifically to the individual questions posed in the document, but rather to identify issues which we believe are of most importance to consumers.

The fourth transmission price control review would appear to be one of the most challenging given the changing structure of the market, the shifts of energy flows across the networks and the Government drive to promote environmentally sensitive energy policies. At the centre of this piece of work, the stakeholders must not lose sight of the primary objective - "***To protect the interests of consumers.***"

This aim is underpinned by a number of elements, which must be considered when devising controls. These will include:

- **All** consumers to be provided with services which meet with their needs
- Reliability in supply
- Services provided at reasonable costs
- Minimising risks to consumers of price increases and encouraging overall price stability
- Removing the potential for costs to be passed onto consumers due to inefficient practices performed by the transmission owners/operators
- Benefits accrued by the owners/operators shared across consumers and shareholders in an equitable manner e.g. windfall gains extracted from sale of assets etc. – it is vital that this is considered both individually and in the round
- Transparency in operation i.e. targeted incentive schemes should deliver the required service levels and be simple to operate and understand

- Adequate penalties should exist to ensure owners/operators perform to the required service levels and such penalties should be appropriately targeted at the entity failing to meet these targets

energywatch believes that these practical considerations should be at the heart of the Price Control Review as ultimately the physical networks are developed to provide “energy carriage” services to consumers.

In terms of the various sub-sections Ofgem identifies in the report, energywatch offers the following comments.

## **RPI-X**

energywatch recommends that the refined RPI-X model continues to be adopted for the foreseeable future. At this stage, particularly cognisant of the fact that the energy markets are going through a period of significant change, we believe that the review period should be maintained at five year intervals.

## **Environmental Policy**

The growth in renewable power generation etc. should be encouraged; however, energywatch understands that environmental related initiatives will generate additional costs for transmission owners/operators. Clearly these costs, where allowed for under the controls, will ultimately be borne by consumers. The allocation of these costs across customer groups is a matter for the pricing methodologies of the individual operators, however, we are unconvinced by the legitimacy of burdening energy consumers with the full costs of implementing government led policies. In our opinion, the effect of the advancement of “environmentally friendly” initiatives is of social benefit and as a result it seems appropriate that the costs of implementation should be shared across **all** benefiting parties. As a result, energywatch proposes that transmission owners/operators should seek funding from government to recover those investment costs incurred to support government environmental policy.

## **Incentives**

energywatch is supportive of the use of explicit incentives where they encourage behaviour which aligns with consumer requirements. In electricity distribution the Information and Incentives Programme (IIP) is a good example of an incentive programme which focuses on customer services and penalises the operator for poor performance. energywatch believes that these simple, but well directed programmes should be encouraged and expanded. We note that no such programme exists in the gas market and would both recommend and welcome a review in taking this forward.

When considering output based incentives, energywatch is extremely wary of developing these further following the industry’s experience of the gas entry capacity auctions. There are many aspects to designing this form of incentive mechanism, which individually can skew the incentive and subsequent

behaviours. The determination of baselines, incremental volumes, economic tests and rewards are all the subject of judgement and lack, at times, economic rigour. The same issues also arise when considering the introduction of sliding scale incentive schemes where an element of reasoned estimation is required when setting target levels and sharing factors.

energywatch is firmly of the view that Ofgem should initiate a thorough review of the various output based and sliding scale incentive regimes as part of the overall price control review. In particular, Ofgem should consider whether the incentive schemes have positively served consumers and whether costs and benefits (and therefore risks) have been fairly apportioned. energywatch believes that such a review is well overdue and would happily discuss with Ofgem taking this proposition forward.

## **OPEX**

The changing structures of the companies involved in the review, in particular the merger of NGC and Transco NTS and the sell off of Transco's DN businesses, will undoubtedly throw up new challenges in identifying shared resources and capitalisation of operating costs. At this stage, it is impossible to forecast the outcome of this element of the review, but our expectation is that significant OPEX efficiencies should be allowed for. energywatch expects that consumers will see the benefits of the merger and network sales and one area where these rewards should be evident is in significant OPEX savings.

Although we are aware of the benefits of comparative regulation we see only marginal benefits in employing this analysis in the review. The most critical part of the review should be to identify where costs are allocated, to remove duplication of resource and to ensure consumers receive the full benefit from the increased economies of scale generated from the restructuring of the businesses.

## **Re-openers**

As a general rule re-openers should be resisted as they conflict with the objective of achieving stability. Ofgem suggests that revenue drivers are a realistic alternative to re-openers and by default should be encouraged. As Ofgem correctly notes, revenue drivers are based on a set of assumptions and liable to produce distorted incentives on the Licensees. Once again, we propose that revenue drivers are examined in conjunction with the review of incentives to ensure that the effects of using this form of incentive are not mis-directed.

## **De-regulation**

energywatch supports the drive to de-regulate the markets where it can be ascertained that de-regulation will produce tangible benefits to consumers. In our opinion, this "test" has not been properly adhered to in the past e.g. meter unbundling. Where it is perceived that de-regulation of a particular service may provide improved services at lower costs then energywatch believes that

such perceptions should be supported by rigorous economic testing. These “tests” should involve all stakeholders and greater consideration should be given to the practical implementation of any de-regulation initiative.

energywatch looks forward to participating in the price control review process and in the meantime if you have any questions relating to this response, or require any further clarification on the points raised then please contact me.

Yours sincerely

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Head of Regulatory Affairs