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Transmission Price Control Review – Initial Consultation July 2005

Dear Robert

We welcome the opportunity to comment on the issues raised in the Transmission Price Control Review initial consultation. This response reflects the views of RWE Npower and the UK based business of RWE Trading GmbH.

The Transmission Price Control Review (TPCR) needs to establish price controls that recognise that the transmission networks will face continued future uncertainty in areas such as connections and supply and demand patterns. Any arrangements need to allow the transmission networks to respond to market dynamics and undertake efficient investment where necessary. We still believe that the monopoly nature of transmission networks means RPI-X remains appropriate together with a 5-year price control period.

The separation of the Transmission Asset Owner (TO) and System Operator (SO) role is well established in both the gas and electricity markets. The scope of these distinct roles should not be blurred and the differences reinforced to ensure efficient choices between physical investment by the TO and the utilisation of system management tools by the SO. As the TO and SO undertake different activities over differing timescales they can be subject to different regulation. The key elements are defining and setting baseline outputs with an associated efficient level of capital and operating costs and determining how the baselines are adjusted going forward.

The structure of price controls implemented will need to balance a number of competing requirements, such as flexibility and stability. They will also need to meet regulatory objectives including protecting the interests of customers, promoting social and environmental objectives, rewarding focused and timely investment and allocating risk appropriately. There will need to be a trade-off between some of these objectives but as drafted, the consultation document

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contains no clear indication of Ofgem's priority policy areas and we would welcome clarity at an early stage. The price controls should also reflect suppliers' needs and should be reasonably stable and predictable year on year within the price control period and, where possible, should minimise volatility moving between price control periods.

This is the first time that Ofgem has reviewed the price controls for all gas and electricity transmission businesses at the same time. There are a number of areas where the arrangements in gas and electricity are different. Ofgem will consider whether the differences remain appropriate and whether there should be consistency of approach between electricity and gas. While it appears reasonable to transpose arrangements between two systems essentially undertaking similar activities, the differences between the two markets needs to be recognised and accepted. We believe that there should be a comprehensive analysis of the performance of the arrangements in each market to date in order to assess their effectiveness. At this time we do not believe a case has been made to move away from an approach based upon licence and other statutory investment obligations allied with a centralised planning model and arguably these obligations conflict with investment decisions based on auctions. This tension has still to be resolved for the gas entry capacity regime. Any fundamental regime changes must be supported by comprehensive Regulatory Impact Assessments to determine the cost-benefit and ensure consistency with Licensees' statutory duties.

As a consequence of the merger between National Grid Group plc and Lattice Group plc to create National Grid Transco plc (NGT) in late 2002, the two largest transmission asset owners are under common ownership. We endorse Ofgem's approach to assess and set independently the Transco NTS and NGC price controls although it may be possible to identify some economies of scope as a result of common ownership. Of particular relevance to the SO incentive arrangements is that any opportunities for arbitraging between gas and electricity markets are explicitly recognised when setting the incentives schemes.

We have set out a number of high-level principles that we believe should underpin the upcoming Transmission Price Control Review, as well as providing more detailed responses to specific issues raised in the consultation, which are appended below. We hope these views are helpful and if you wish to discuss them further please contact Terry Ballard on 01793 892715 or Charles Ruffell on 01793 893983.

Yours sincerely

Charles Ruffell
Economic Regulation

Specific Questions Raised

Framework, context 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 structure of the price controls will need to reflect continued uncertainty in connections, patterns of supply and demand across each transmission network (e.g. offshore renewable generation and development of new gas storage or importation facilities). However, there has always been some uncertainty when setting price controls so the concerns should not be overstated. Also, Ofgem should consider that from a supplier perspective there is a need for stability and predictability and adequate information released to set prices. The current gas auction arrangements do not provide this. We are pleased to note that the conclusions from the post project review of the Distribution Price Control are to be considered in the transmission reviews. We welcome the proposal to establish as much of the policy framework as possible at an early stage of the project. We also support the use of workshops during the process. We hope the proposed timetable is sufficiently flexible to ensure that this takes place.

The post project review also noted that Ofgem would give further consideration to the issue of revenue over or under recovery against regulatory allowances and, in particular, the impact on tariff changes compared to those which would be expected under the base price control. This can be aided by ensuring that sufficient information is released to market participants in order that they may monitor performance during the price control period particularly in relation to under and over recovery reporting.

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 that should be price-regulated differently, including any scope for de-regulation?

We continue to believe that RPI-X is appropriate for providers of monopoly transmission services. This is likely to remain the principle form of control in practice with any supplementary incentive schemes likely to reinforce efficiency only at the margin. Transmission price controls have been progressively unbundled which improves transparency, correctly allocates costs and exposes those services that could be provided competitively. We would support continuing this to the extent that there is a reasonable expectation that alternative service providers would emerge.

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

There should be a balance between reviewing and assessing performance under the current price controls and developing stable and developing forward looking controls from 2007 to reflect the fundamental changes in the markets that have already been identified. Economies of scope resulting from common ownership of the gas and electricity networks should be identified. A significant 'risk premium' was included in the SO incentive scheme for 2005/6 to accommodate BETTA. This should be reviewed in the light of experience.

Should incentives to reduce costs be strengthened or weakened?

Historic performance needs to be reviewed and, to the extent that incentives are used, then they should be set to stretch performance and should appropriately balance the risk/reward between the service provider and users of their system. Targets set in the past have been consistently met and/or exceeded. This would suggest that cost reduction targets should be made more stretching.

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?

The availability of a rolling incentive mechanism in the gas entry capacity auctions has not of itself led to long term incremental investment. However, rolling incentives may address the natural incentive under the five-year price control to profile investments to maximise returns.

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

Yes, it would ensure that economically efficient action is taken whilst removing the temptation to allocate expenditure such that it optimises returns under differing incentive regimes.

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

Ofgem has set out its objectives and given gas-electricity convergence it is reasonable to consider both markets together. However, they must avoid merely transposing arrangements between the two markets unless there are demonstrable benefits. We strongly believe that Ofgem should undertake a fundamental review of the gas entry capacity arrangements and this should be set as another objective. In addition, we do not think that the balance of risks associated with licensees meeting contractual requirements through means other than providing physical capacity is correct. The interaction between this and the buy-back incentive further dilutes any auction signals and this should also be included. The SO incentives are extremely complicated and are difficult to understand and interpret. To this extent we believe there would be benefit in the SO regularly publishing not just the core data that drives the incentive calculations but summarised data showing performance against incentives and the financial impacts that will result for themselves and users. Where these arrangements can be simplified then they should be and they should not be made any more opaque.

Assessing costs

Ofgem should continue to use external advisers to assess costs estimates submitted under the TPCR.

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?

Cost reporting needs to be more transparent, particularly the various SO incentive schemes. It is appropriate that capital and operational expenditure is reported in differing timescales to reflect its value to the market. We support the continued incentive for operational costs and standardisation of reporting as introduced under DPCR4.

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?

At this time we see no compelling reasons to move away from an approach based upon licence and other statutory investment obligations allied with a centralised planning model. The experience of long-term gas entry capacity auctions has done nothing to alter our views of the suitability of auctions in this context. In our responses to the 2002 Transco price control consultations and since, we have consistently questioned the effectiveness of gas entry capacity auctions. The long-term auctions held to date have not produced strong enough investment signals for Transco to sell incremental capacity, in spite of a generous incentive scheme. Indeed, as Transco itself notes in its Incremental Entry Capacity Release statement

“To continue developing a flexible and responsive NTS, Transco NTS believes it is important to seek wide views on the process for determining how it invests in its network as well as on the underlying assumptions that underpin such investment. Transco NTS has consistently argued that it does not believe it is appropriate to rely on entry capacity auctions alone to provide investment signals. Transco NTS intends, therefore, to continue to develop a planning approach that draws upon views of a range of stakeholders across the gas chain, and will continue to aim to invest where this is necessary to meet statutory obligations. As now, Transco NTS will publish its conclusions within the Ten Year Statement”. The example of gas entry terminals is a good illustration of Transco’s reluctance to base investments on auction signals despite there being a reasonable level of competition and potential buyers of entry capacity having a good idea of their future gas purchase obligations. To replicate these arrangements for gas exit capacity and for entry on and exit from the electricity transmission network where there is less certainty and competition and the current arrangements also work well is not appropriate.

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 intrinsic requirement for consistency. There are fundamental commercial, physical and operational differences between gas and electricity transmission and entry to and exit from the networks and we see no compelling reason why different arrangements should not persist providing these meet the needs of network users and provide the correct signals to network owners. However, we do recognise that a degree of compatibility is necessary to avoid distorting decision making between the gas and electricity markets

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?

Based on the gas entry capacity experience, we have serious doubts over the benefits of an approach based on the requirement to make long-term firm financial commitments. We see no reasons for changing the current arrangements that have generally delivered sufficient capacity and are simple and cost-effective. For large scale connections, that require significant financial commitment from all parties, we would support bi-lateral contracts of the type (ARCA) adopted in the gas market, rather than via long-term auctions.

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? 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?

The baseline outputs should be set in a manner consistent with the prevailing commercial arrangements for securing capacity. They do not necessarily have to be the same for gas and electricity.

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?

Our preference would be for stability so we would support price controls that adjust automatically rather than setting them in the expectation that they will be reopened providing that the initial baseline is set at a realistic level. Stability will be of benefit to asset owners, users and customers

Financial issues

Are there any other factors that Ofgem should consider in assessing financial issues under this price control review?

We would not expect fundamental changes to technical financial decisions taken as part of previous price controls. An example would be changing the decision to adopt an unfocused approach in establishing Transco's RAV in 2002.