**COST RECOVERY AND INCENTIVE MECHANISM FOR TRANSMISSION INVESTMENT FOR RENEWABLE GENERATION BASELINE PROJECTS**

This guidance note sets out the Authority's intentions for the licence conditions that establish the transmission investment for renewable generation (TIRG) revenue allowance mechanism.

The cost recovery and incentive mechanism arrangements dealt with in this guidance note are for the four transmission investment for renewable generation baseline projects identified in the December 2004 final proposals for TIRG[1]: Beauly-Denny, Scotland-England interconnector, Sloy reinforcement and South West Scotland.

This guidance note considers the individual components of the TIRG revenue allowance mechanism:

- pre construction and contingency revenue allowance (IPTIRG);
- construction period revenue allowance (FTIRG);
- five year incentive period revenue allowance (ETIRG);
- regulated asset value revenue allowance (ATIRG); and
- the associated adjustments to the revenue allowances, where appropriate.

This guidance note provides information and guidance on an informal basis and should not be treated as binding on the Authority. Nothing in this guidance note is to be construed as granting any rights or imposing any obligations on the Authority. It does not fetter the Authority's discretion with respect to the administration of the TIRG revenue allowance mechanism. For the avoidance of doubt, where there is any conflict between the terms of the licence conditions that establish the TIRG revenue allowance mechanism and this guidance note, the terms of the relevant licence conditions will take precedent.

***Pre construction and contingency revenue allowance (IPTIRG)***

*TIRG final proposals*

The December 2004 final proposals document suggested that it would be possible to treat forecast pre construction and contingency costs in a similar way to other construction costs.

In developing this TIRG revenue allowance mechanism, Ofgem considered a range of options to allow for cost recovery of pre construction costs. The licensees contributed to this discussion.

*Licence drafting*

Initially, Ofgem considered allowing the licensees to recover pre construction and contingency costs at the end of the pre construction period, as a lump sum (including an allowed rate of return, on the basis of the costs being treated as capitalised). However, after further consideration Ofgem considers that the best approach would be to allow an annual cost pass through of forecast pre construction and contingency costs incurred during the pre construction period, with indexation. The preconstruction and

[1] Transmission investment for renewable generation, final proposals, December 2004

contingency revenue allowance could be adjusted upwards or downwards through an income adjustment where additional efficient costs have been incurred (or saved) in relation to the transmission investment project and where such an adjustment has been notified to, and approved by, the Authority.

During the pre construction period of each transmission investment project, the licensee will recover the forecast pre construction and contingency costs set out in the schedule to the licence.

The licensee will be required to provide a pre construction expenditure report to the Authority for each year of the preconstruction period setting out the annual pre construction and contingency costs incurred in relation to the transmission investment project, as set out in the reporting obligations within the associated special condition.

*Adjustments to pre-construction and contingency revenue allowance (TIRGIncAd)*

The preconstruction and contingency revenue allowance may be adjusted as a result of a TIRG income adjusting event. A TIRG income adjusting event is an event or circumstance occurring in the pre construction period which causes costs/expenses to be incurred or saved in relation to the transmission investment project, where those cost/expenses:

- (a) result in, or are expected to result in a *material* change to the forecast pre construction and contingency costs for the transmission investment project;
- (b) have been, or are expected to be, efficiently incurred or saved; and
- (c) can not otherwise be recovered under the TIRG revenue allowance.

It is likely that the Authority will interpret a *material change* to the forecast pre construction and contingency costs as an increase or decrease of greater or less than 0.5 per cent of the total forecast project spend for that transmission investment project. This de minimis level is broadly in line with the de minimis level for transmission system operation related income adjusting events.

An example of a relevant event is an amendment to the scope of the preconstruction works which is necessary to comply with the terms and conditions of a planning consent.

The licensee is required to notify the Authority where it considers that a TIRG income adjusting event has occurred. Notification must be given as soon as is reasonably practicable after the event occurs, and in any event no later than three months after the end of the relevant year in which the event occurs, unless the Authority specifies a later date. The licensee will be required to provide information to the Authority on:

- the reasons why the licensee considers the event to be a TIRG income adjusting event;
- the costs or savings arising from the event and how these costs or savings have been calculated;
- the amount of any material change in the forecast pre construction and contingency costs arising from the event and how this amount has been calculated;
- the reasons why these costs cannot otherwise be recovered under the TIRG revenue allowance;

- the amount of the income adjustment allowance requested and how this has been calculated; and
- any other relevant information.

When the Authority receives a TIRG income adjusting event notice it will determine whether a TIRG income adjusting event has occurred and if so what the income adjustment allowance should be. If the Authority determines that an income adjusting event has not occurred the income adjustment allowance will be zero.

For the avoidance of doubt in making its determination on whether an event is a TIRG income adjusting event the Authority will not take into account whether or not the project proceeds to construction.

The income adjustment allowance will, as far as reasonably practicable, be determined on the basis that the licensee's financial position and performance will remain the same as if the event had not taken place. The Authority will publish the determination and may revoke it with the consent of the licensee.

When a licensee notifies the Authority of a change of costs/expenses under the TIRG income adjusting mechanism it must ensure that these costs/expenses have not already been included in the TIRG revenue allowance and will not be recovered through other revenue recovery arrangements.

For the avoidance of doubt there can be more than one TIRG income adjusting event for each TIRG investment project.

*Adjustments to forecast pre-construction timetable*

The licence conditions set out a pre-construction allowance for a fixed pre-construction period for each transmission investment project. In the event that the pre-construction timetable is extended, it is not anticipated that the licensee would be able to earn a revenue allowance for the addition years of pre-construction.

However in exceptional circumstances the Authority may consider an amendment to the forecast pre-construction timetable to enable the licensee to earn a pre-construction revenue allowance during the additional pre-construction years. Such a change would require a modification to be made to the licence conditions under section 11 of the Electricity Act 1989.

Any submission from the licensee relating to delays in the pre-construction timetable due to exceptional circumstances will be considered on a case by case basis.

***Construction period revenue allowance (FTIRG)***

*TIRG final proposals*

Ofgem proposed that the revenue allowance during the construction period would be on the basis of forecast construction costs and a fixed construction period.

*Licence drafting*

The licensee's forecast year on year project costs for each transmission investment project are set out in the schedule to the licence (based on December 2004 final proposals costs).

During the construction period of each transmission investment project, the licensee will earn an allowance which will be the cost of capital on the average asset value of the project (FTIRGC) during each year of construction.

The licensee will be required to provide a construction expenditure report to the Authority for each year of the construction period setting out the annual construction costs incurred in relation to the transmission investment project, as set out in the reporting obligations within the associated special condition.

*Adjustments to forecast construction costs (AFFTIRG)*

The TIRG revenue allowance mechanism is designed to encourage timely delivery of network investment. However, an asset value adjustment may be required where a TIRG asset value adjusting event occurs. A TIRG asset value adjusting event is a relevant asset value adjusting event which is expected to cause costs/expenses to be incurred or saved in relation to the transmission investment project, where those cost/expenses:

(a) are expected to result in a *material* change to the average asset value for the transmission investment project;
(b) are expected to be efficiently incurred or saved; and
(c) can not otherwise be recovered under the TIRG revenue allowance.

Again, it is likely that the Authority will interpret a *material change* to the average asset value as an increase or decrease of greater or less than 0.5 per cent of the average asset value for that transmission investment project. This de minimis level is broadly in line with the de minimis level for transmission system operation related income adjusting events.

Relevant asset value adjusting events are set out in the licence condition. The licence condition describes two types of events - preconstruction work which the licensee expects to be carried out in the construction period in order to comply with the terms and/or conditions of a statutory consent, and an amendment to the scope of construction works which is necessary in order to comply with the terms and conditions of a statutory consent or technical/engineering/planning constraints which have been identified during preconstruction works.

The licensee will need to provide the Authority with notice that a TIRG asset value adjusting event has occurred as soon as is reasonably practicable after the event has occurred, and in any event prior to construction commencing, unless the Authority specifies a later date. The licensee will be required to provide the following information:

- the reasons why the licensee considers the event to be a TIRG asset value adjusting event;
- the costs or savings expected to arise from the event and how these costs or savings have been calculated;
- the amount of any material change to the average asset value as a result of the event and how this amount has been calculated;
- the reasons why these costs can not otherwise be recovered under the TIRG revenue allowance;
- the amount of the asset value adjustment allowance requested and how this has been calculated; and

- any other relevant information.

The notice must be accompanied by an independent technical advisor's statement setting out the additional preconstruction works / amended scope of the construction works (as appropriate) and an independent auditor's statement confirming that the costs stated in the notice fairly represent the costs that are expected to be incurred or saved by the additional preconstruction works / amended scope of construction works (as appropriate).

When the Authority receives a TIRG asset value adjusting event notice it will determine whether a TIRG asset value adjusting event has occurred. If the Authority determines that a TIRG asset value adjusting event has occurred, the Authority will assess whether the transmission investment project will remain economically efficient as a result of the event.

Criteria for the efficiency test is likely to include a comparison of the proposed adjusted investment costs assessed against the likely level of connection activity and constraint costs associated with that transmission investment project, at that point in time. Other criteria may also be taken into account. General criteria will be published for consultation prior to an AFFTIRG decision being made by the Authority.

If the Authority determines that the transmission investment project will remain economically efficient, the Authority will determine what the asset value adjustment allowance should be. The asset value adjustment allowance will, as far as reasonably practicable, be determined on the basis that the licensee's financial position and performance will remain the same as if the event had not taken place.

When a licensee notifies the Authority of a change of costs/expenses under the TIRG asset value adjusting mechanism it must ensure that these costs/expenses have not already been recovered in the TIRG revenue allowance or will not be recovered through other revenue recovery arrangements.

For the avoidance of doubt there can be more than one TIRG asset value adjusting event for each TIRG investment project.

*Adjustments to forecast construction timetable*

The licence conditions set out a construction revenue allowance for a fixed construction period for each transmission investment project. In the event that the construction timetable is extended, it is not anticipated that the licensee would be able to earn a revenue allowance for the addition years of construction.

However in exceptional circumstances the Authority may consider an amendment to the forecast construction timetable to enable the licensee to earn a construction revenue allowance during the additional construction years. Such a change would require a modification to be made to the licence conditions under section 11 of the Electricity Act 1989.

Any submission from the licensees relating to delays in the construction timetable due to exceptional circumstances will be considered on a case by case basis.

**Five year incentive period revenue allowance (ETIRG)**

*TIRG final proposals*

Ofgem proposed that once construction of the transmission investment project has been completed, assuming that the licensee was able to deliver the appropriate output measures, then it would receive an allowance for depreciation and return based on the forecast average asset value. Ofgem considered that any under delivery of outputs could result in a scaling back of allowances for depreciation and returns.

*Licence drafting*

In line with the final proposals, the five year incentive revenue period commences at the commissioning date for each project. When the project is commissioned, the licensee will provide a post construction technical report to the Authority, accompanied by a construction completion certificate, confirming the extent to which the agreed output measures have been delivered. A separate report will also provide details of the actual project spend (post construction expenditure report).

During the five year incentive revenue period the licensee will be able to recover an allowance (consisting of return equal to the permitted cost of capital and an allowance for depreciation) based on the forecast average asset value for each transmission investment project, as set out in the schedule to the licence condition.

As set out on the final proposals, any under-delivery of output measures (or amended output measures) will be reviewed and incentive revenue allowances for depreciation and returns may be scaled back to reflect the under delivery of the output measures. This will be achieved through an adjustment to forecast average asset value for the project (SAFRTIRG).

*Adjustments to forecast average asset value (SAFRTIRG)*

SAFRTIRG is an adjustment to the average asset value for the transmission investment project (ETIRG) and is based on an adjustment to the opening asset value for the transmission investment project (SAFTIRG). SAFTIRG will be determined by the Authority prior to the first relevant year post commissioning date ($t = n + 1$). In making its determination the Authority will have regard to:

(a) whether the transmission investment expenditure was efficiently incurred;
(b) the extent to which the licensee delivered the output measures;
(c) any approved asset value adjustment (AFFTIRG adjustment); and
(d) any other relevant information.

Each assessment of an adjustment to the average asset value for the transmission investment project will be made on a case by case basis, in consultation with the licensee and other interested parties. It is unlikely that the average asset value will be increased where the licensee has overspent and out performed the output measures (unless the licensee can demonstrate that any variation in costs made as a result of providing the additional output measures outweigh the costs associated with the provision of the additional output measures). This approach should avoid unnecessary gold plating.

*Adjustments to the output measures*

The TIRG revenue allowance mechanism is intended to ensure that investment projects are delivered to pre agreed output measures. Consequently, the output measures have been defined in the licence.

However, an adjustment to the output measures may be required in the event that the scope of construction works changes and the Authority is satisfied that a material change to the output measures has occurred as a result.

The licensee will need to provide the Authority with notice that a TIRG output measures adjusting event has occurred as soon as is reasonably practicable after the event has occurred, and in any event prior to construction commencing, unless the Authority specifies a later date. The licensee will be required to provide the following information:

- the reasons why the licensee considers the event to be an output measures adjusting event;
- the proposed output measures adjustment arising from the event and an explanation of how the output measures adjustment has been calculated; and
- any other relevant information.

When the Authority receives a TIRG output measures adjusting event notice it will determine whether a TIRG output measures adjusting event has occurred. If the Authority determines that a TIRG output measures event has occurred, the Authority will publish a notice with the revised output measures and the reasons for the determination. The Authority may revoke the notice with the consent of the licensee.

**Regulated asset value revenue allowance (ATIRG)**

*TIRG final proposals*

The December 2004 final proposals document considered that after five years the TIRG revenue allowance would be calculated on actual costs determined by the Authority to be efficiently incurred, rather than forecast costs.

*Licence drafting*

The draft licence conditions provide for a value for ATIRG for each transmission investment project to be determined by the Authority prior to the end of the incentive period.