



Electricity and gas transmission businesses and other interested parties.

Promoting choice and value to customers

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1 February 2006

Dear Colleagues,

Transmission Price Control Review (TPCR): Capital expenditure projections 2007 - 2012

Ofgem is developing revised price controls for the gas and electricity transmission companies to apply from 1 April 2007. In December 2005, we published our second consultation document¹ as part of this review, with responses due by 30 January 2006.

The transmission companies have recently provided information concerning their capital expenditure projections. Given the size of these we have decided to set out the key issues relevant to the capex projections and invite views at this time.

This letter summarises the capital expenditure projections that have been provided by each transmission company, highlighting the potential scale of the proposed investments, the totals of which range between £7.1 billion to £9.2 billion. Key points are that:

- Electricity transmission companies suggest that they will need to invest, in total, some £5.7 billion to £7.3 billion in upgrading their network between 2007 and 2012. This investment is expected to take place within the context of a combined current asset base of around £6 billion and combined capital expenditure allowances of £2.5 billion in the last price control period;
- National Grid Gas suggests that it will invest some £1.4 billion to £2 billion in the gas transmission network over the same period (i.e. 2007 to 2012). This investment is expected to take place within the context of a current asset base of around £2.5 billion and capital expenditure allowances of £890 million over the current price control period;
- Some £3.7 billion to £5.8 billion of the forecast investment is load-related (LR), but there is significant uncertainty about the size, location and timing of new projects, which makes the actual investment requirement difficult to predict. This scale of investment highlights the benefit for users signalling their requirement for network capacity in an effective manner; and
- Some £3.4 billion of the forecast expenditure in non load-related (NLR), with some £2.6 billion for electricity asset replacement.

The TPCR will set capital expenditure allowances for the period 2007-2012 sufficient to for each company to finance its activities and at the same time, to protect the interests of consumers. We estimate that, if allowed, the cost to customers of financing this new

¹ Transmission Price Control Review, Second consultation, December 2005 277/05

investment could be in excess of £650m per year² by the end of the forthcoming price control period. The ongoing cost of financing the capital expenditure allowance over the current five year period is around £260m per year.

Company capital expenditure forecasts

Gas and electricity transmission companies are facing several business challenges, including the need for significant investment in the transmission system:

- to accommodate new energy sources (e.g. new gas entry terminals and renewable generation); and
- to replace ageing network assets.

We expect these challenges to continue during the period for which the revised price controls will apply

At the end of December, we received the companies' responses to our forecast business plan questionnaire ("FBPQ"). These responses set out the cost projections of each transmission company for the period 2007-2012, together with the key business planning assumptions and supporting information.

Appendix 1 to this letter shows the potential investment requirements of each of the transmission companies should the appropriate consents for investment projects be obtained.

Ofgem's current thinking on the forecast level of capital expenditure

We intend to publish our third consultation document in March 2006, which will set out preferred options for the price control design and initial thoughts on the historic costs of the companies. We have not yet undertaken any detailed analysis of the companies' submissions for the coming period. Consequently, we are not able to form a view on the appropriate level of the capital expenditure allowances at this stage. We intend to set out initial proposals for capital expenditure allowances in June.

It is important that investment is both efficient and timely as this is, amongst other things, in the best interests of consumers. We aim to design the price controls to provide appropriate incentives to facilitate the delivery of efficient and timely investment throughout the forthcoming period. In December, we consulted upon a range of price control design options that would help address some of the uncertainties surrounding the timing and location of new incremental investments. This included developing options for revenue drivers and other mechanisms to provide additional revenues to finance incremental investment as it is needed.

Ofgem will again work with its consultants to establish allowances for the baseline investment, a significant element of which will relate to asset replacement expenditure. We will be looking to each of the transmission companies to provide detailed evidence and supporting information to justify their expenditure projections. A particular issue to be considered is each company's approach to managing network risks.

In December, we also identified some concerns regarding the access regimes in the electricity and gas sectors. A key issue is the need for users to signal their commitment to use network capacity in the future to avoid unnecessary investments being undertaken or stranded assets. It is anticipated that these issues will be developed further as the TPCR consultation process progresses.

² using an illustrative real pre-tax return of 6.25 per cent, an illustrative depreciation charge of 2.5 per cent, and an annual inflation rate of 2.6 per cent per year.

Responding to this open letter

We would like to hear the views of interested parties in relation to any of the issues set out in this letter. We would in particular welcome views on the following:

1. The factors that should be taken into account in the TPCR given the potential scale and uncertainty of forecast capital expenditure?
2. What other factors, or alternative approaches, should Ofgem take into account in designing the incentive framework to ensure that transmission companies finance their capital investment plans in a timely and efficient manner, and serving the interests of consumers?
3. How might we address the issue of fully depreciated pre-Vesting assets to ensure that they are replaced according to need rather than to replace the lost value?

We request that responses are submitted by no later than 1 March 2006 and should be sent to:

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Director, Transmission
Office of Gas & Electricity Markets
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London
SW1P 3GE

Email: TPCRresponses@ofgem.gov.uk
Tel: 020 7901 7050
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Unless marked confidential, we will publish all responses by placing them in Ofgem's library or on the website (www.ofgem.gov.uk). We therefore ask that responses are submitted both electronically and in writing. Respondents are also asked to put any confidential material in appendices to their responses so that a non confidential summary can be published.

Any questions on this document should, in the first instance, be directed to Colin Green, who can be contacted on 020 7901 7143 or by email at colin.green@ofgem.gov.uk.

Yours sincerely

David Gray
Managing Director – Networks

APPENDIX 1 – COMPANY CAPITAL EXPENDITURE FORECASTS 2007-2012 (2004/05 prices)

There main highlights are that:

- The capital expenditure forecasts are forecast to range between £7,100 million to £9,200 million, compared to £2,500 million in the current controls. Overall, the capital expenditure forecasts represent a potential doubling of the combined Regulatory Asset Value of the transmission businesses over the next 5 years.
- These forecasts are dominated by the National Grid transmission businesses, which project expenditure requirements of around £5,300 million over the forthcoming price control period compared with the £2,300 million in the current price control period. They have identified a further £700 million of potential investment (mainly gas entry investments) that relates to projects that will probably proceed, although the timing is presently uncertain, bringing the potential National Grid total to some £6,000 million;

Non load related expenditure

- Of this £6,000 million total investment requirement for National Grid, National Grid Electricity Transmission plc (NGET) has forecast around £2,500 million of non load-related expenditure, compared with £790m allowed in the current price control period. This is mainly driven by a proposed large increase in anticipated asset replacement activity;
- SP Transmission Limited (SPTL) has indicated a need for £367 million of non load-related expenditure to finance a large asset replacement programme, compared with £136 million allowed in the previous price control period;
- Scottish Hydro-Electric Transmission Limited (SHETL) has identified £56 million of non load-related expenditure, which is broadly in line with the allowances in the previous period.

Load-related expenditure

- both Scottish transmission companies have also identified a significant amount of load driven investments that may be incurred during the coming period. SPTL has identified some £350m of load-related expenditure within its plan. SHETL has indicated that it will potentially need to finance £1,100 million³ of load related investment based upon their best view of renewable generation that succeeds in obtaining the appropriate consents. This may rise to £2,400 million if all current connection requests proceed to construction stage;

The companies have set out views on the possible approaches for dealing with investment uncertainties and in some instances set out possible mechanisms for enabling revenues to move in line with actual investments made rather than relying upon forecasts.

³ approximately £127 million of the total is non-TIRG related entry investment.

Licensee	Capital expenditure allowance (current price control) ⁴ £m	Capital expenditure allowance (extension) ⁵ £m	Regulatory Asset Value 31 March 2005 £m	Forecast expenditure 2007/08 – 2011/12				
				Load - related: Entry £m	Load - related: Exit £m	Load - related: General £m	Non load related expenditure ⁶ £m	Total £m
National Grid Gas plc	861	N/A	2442	492	390	41	458	1381
National Grid Electricity Transmission plc	1453 - total (662 – LRE, 791 – NLRE) ⁷	467 – total (215 – LRE, 252 – NLRE)	5152	268	407	737	2502	3914
National Grid total	2314	467	7594	760	797	778	2960	5295
SP Transmission Ltd	152 – total (16 – LRE, 136 – NLRE)	169 – total	705	182 ⁸	28	148	367	725
Scottish Hydro-Electric Transmission Ltd	71 – total (13 – LRE, 58 – NLRE)	43 – total	272	1005 ⁹	26	6	56	1093
Total	2537	679	8571	1947	851	932	3383	7113

Companies have identified a further £2,100 million of capital expenditure that might be incurred during the next five year period:

- NGG: approximately £600 million of possible further investment triggered by new gas entry points;
- NGET: approximately £100 million of investment for renewable connections; and
- SHETL: £300 million to £1.4 billion of investment for renewable connections.

It is important to note that this also excludes investment in offshore transmission network.

⁴ For NGG represents the period 2002-2007, for NGET represents the period 2001-2006, and for both SPTL and SHETL represents the period 2000-2005.

⁵ For NGET represents the period 2006/07, and for both SPTL and SHETL represents the period 2005-2007.

⁶ excludes SO capital expenditure, which amounts to a further £114m (£67m in Gas, £47m in Electricity)

⁷ excludes the impact of the Gt term.

⁸ excludes TIRG investments.

⁹ includes around £900m of TIRG investment.