



## **Transmission Price Control Review – Second Consultation Response by Association of Electricity Producers**

30 January 2006

Introduction The Association welcomes the opportunity to contribute to the development of the 2007 Price Control Review and applauds Ofgem's early and ongoing 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 6 – Price Control Design Options - Framework**

*♦ Is Ofgem's focus on the 'user commitment' option appropriate or are there other traditional price control options that might better meet Ofgem's objectives for the TPCR, particularly in the context of the Authority's statutory and other legal duties.*

At the outset we would like to reiterate a long-held view of the Association that it is not necessary that access arrangements for electricity must be common with those for gas networks. There are profound physical differences between the products transported, as well the differences in the market arrangements. Changes to the current arrangements for either gas or electricity must demonstrate material benefits compared with the status quo and should be seen in the context of the relative materiality of the cost of the commodity compared with the costs of transmission, for electricity, roughly a factor of 10:1.

The Association is not opposed to 'user commitment' models as such and considers that there is a wide spectrum of models that fall under this heading, including for gas the current ARCA model or a variation of it. The Association is however concerned that simply overlaying entry type arrangements to exit where there are many more nodes will give rise unwarranted complexity and cost, particularly when the document does not demonstrate the entry arrangements have delivered more efficient investment. We query whether this would be a proportionate response to issues which may or may not arise in the future at offtake and it is hard to understand how this would be

consistent with the objectives of simplicity and transparency and minimisation of implementation costs. This is a particular concern where models look beyond incremental capacity requirements to allocation of all capacity.

Ofgem is rightly keen to promote efficient investment and seek to avoid unnecessary investment as this may result in additional costs being passed on to customers but it also notes the risks of underinvestment which in itself would carry a significant cost. It would be helpful and inform discussions if investment made in recent years which has become stranded could be described and ideally quantified. In the context of gas transmission companies making investment decisions we note the 1 in 20 obligations on transporters and expect an ongoing role for the traditional planning methods alongside any new arrangements to ensure compliance with this obligation.

*♦ What is the appropriate allocation of investment risk between network users (both generally and at specific locations), transmission companies and consumers during different phases, planning & design, construction and operation*

The Association considers that some kind of risk sharing is appropriate and that it is probably reasonable for the balance of this to vary during the course of a project. However it is important that the terms for connection are fair and equitable and applied consistently to provide regulatory certainty when developers are making investment decisions. An issue that warrants further consideration here is the growing mismatch between the lead time for the provision of offtake capacity and the time taken to build gas fired generating plant.

*♦ Is it appropriate to seek to separate, both formally and operationally, the issue of how charging and reserve prices are set at gas entry from the issue of how incremental revenues are determined under the price control?*

The Association considers that unintended consequences may arise if reserve prices and revenue drivers are established separately. When UCAs for entry were initially set there was an expectation that these values and the associated reserve prices would remain fixed for the price control period, providing a degree of stability and certainty in charges. A move away from this would need to consider the possible impact on under / over recovery of allowed revenues and changes in behaviour in the auctions as participants judge whether reserve prices are likely to rise or fall in future years.

In principle both reserve prices and revenue drivers should derive from the long run marginal costs with the expectation that these should be reasonably stable during a price control period, with relatively minor adjustments between periods. The fact that this is currently not the case may derive from the methodology for establishing UCAs in the first place not being robust to potential future developments. We consider this needs more consideration before a decision to formally separate the setting of reserve prices and

revenue drivers. We expect the Gas TCMF to provide a further insight into this.

## **Chapter 7: Incentive options - Gas**

### Revenue drivers for entry and exit

♦ *Should the revenue driver be nodal, zonal or global? What are the advantages and disadvantages of these different options and to what extent do these advantages and disadvantages differ between entry and offtake? If a zonal approach is preferred then how might zones be defined?*

A decision over whether revenue drivers are nodal, zonal or global will need to consider if the derivation of the values to be used will vary according to location or whether the value is relatively constant irrespective of location. If there was a large variance between the cost and the associated revenue driver then National Grid may favour investment in certain locations over others or being under or over rewarded for the incremental capacity put in place.

♦ *What are key cost drivers of incremental capacity – and how might these vary between entry and offtake? How should these be quantified*

The cost drivers will be divided between materials costs which would be consistent per km of pipe whether the pipe was for entry or exit related investment although this would be vulnerable to steel price variations. Other costs will relate to those concerned with obtaining consents and actually putting the pipe in the ground, these will vary more with locations, type of ground and complexity of the work being undertaken.

*Should revenue drivers be fixed for the price control period or should they be adjusted during the price control period*

Fixing these will give some certainty to NG, but may not reflect actual costs if these vary during the price control period. Any difference in the two could influence NG investment decisions.

### Approaches to offtake reform

♦ *Do you believe that Ofgem's proposals for a long term user commitment model are appropriate?*

We consider that it is too early to judge whether the proposals are appropriate. At this time they exist only as high level principles and there is limited understanding of how the models may work in practice including the definition of zones. Nor is there any consideration of the interactions and interdependencies of the options for baselines, incentives and charges. So for example any model that might seem appropriate with a particular baseline / incentive package is less appropriate in combination with a different baseline incentive package. We also note there has been little consideration of the

flexibility product under the Ofgem proposals nor how these proposals may affect sites that are currently interruptible.

*♦ Are there any alternative models, including those which are characterised as variants of the status quo that would meet the defined objectives?*

We expect there will be other models that could meet the defined objectives. National Grid presented a number of options at the EOWG meeting on 18<sup>th</sup> January in relation to the flexibility product or a combined 'flat' and 'flex' product and the concept of a 'negative ARCA' has been raised. These product and allocation options would seem worthy of further consideration as they may go a long way toward meeting the objectives and other options may emerge in the coming weeks. We believe it would be inappropriate for Ofgem to express a preference for any one option at this stage; rather it may be better to develop all options further to gain a better understanding of how the whole package of measures may work, and then eliminate options as it becomes apparent they are outliers against a number of parameters. Then a more meaningful assessment of a smaller number of options should be undertaken, when it may be necessary to consider trade offs between the extent to which the objectives are satisfied in the context of benefits and costs for each option.

#### Offtake product definition and baselines

*♦ Which options described for product definition and baseline determination do you believe is most appropriate*

The Association considers it is premature to express a view on Ofgem's options when other options are still under development. In particular when there is limited understanding of how the arrangements will work in practice. However we expect nodal type products are most likely to act in customer interests by providing certainty over capacity bookings

*♦ Are there any alternative models that would meet the defined objectives?*

We expect that alternative approaches are capable of meeting the objectives and that these will emerge in the coming weeks. It is possible that options which provide for products more suitable to particular connectee types may deliver a more efficient solution than a 'one size fits all' approach and we urge Ofgem to keep an open mind in this regard.

*♦ Should the baselines be fixed for the five year period, or increase over time?*

It may be appropriate here to consider different approaches for different offtake points consistent with the characteristics of the point. Clearly DNs with obligations to meet 1 in 20 demand are likely to have a need for frequent but relatively small capacity increments whilst direct connects will only require

large increments infrequently if at all. Hence a different approach to baselines may be appropriate.

♦ *What method of determination of baselines is most appropriate for the determination of the level of offtake baselines?*

Until the interaction of the baseline options with the product options and incentives is better understood it is not timely to comment on this. The baseline approaches for sites that are currently firm or interruptible will need particular attention.

♦ *What threshold should trigger the release of incremental capacity e.g. a percentage of the deemed cost of providing the incremental capacity, a fixed number of years of commitment or another approach.*

The trigger should be simple and transparent consistent with the objectives

♦ *How should NG NTS be incentivised to release incremental capacity as soon as possible, and should the limit on release be set as a fixed period, for example, three years or linked to a fixed interval once the relevant planning consents have been obtained.*

This needs further consideration and different approaches may be appropriate at different offtake points, consistent with the needs of the connectee and the project being undertaken. 'As soon as possible' may not always be appropriate. It may be better to think in terms of the desired timescale of the connectee. Once a firm date has been set we consider there should be strong incentives to deliver to this date and penalties for failure.

However in this context we note that, irrespective of any mechanism to signal the need for capacity, the decision to invest or not and the timescale for this rests with NG with due regard to its licence obligations.

#### Buy-back incentives for entry and offtake

♦ *Would it be appropriate to treat buy backs from operational constraints differently compared with buy-backs resulting from delayed investment for incremental capacity? If so, should there be two different buy-back mechanisms and what would the advantages and disadvantages be? How could we distinguish between the two types of constraints?*

The Association considers it may be appropriate to treat these types of buybacks separately, but it will be important to first assess whether the two types can be distinguished. The objectives of simplicity and transparency are clearly important here.

#### Interactions between entry and offtake options

♦ *What are the main interactions between entry and offtake, and how does this affect the approach to baselines, revenue drivers and buy-back mechanisms?*

The clearest interaction will be at bi-directional points with similar issues where offtake points are close to entry points. Storage connections and bi-directional interconnectors, where the same parties have interests in both entry and exit capacity, require clarity on how these interactions will be addressed to avoid the need to signal incremental capacity requirements via entry and exit processes and potentially funding the same piece of work twice over.

♦ *Should the same approach to baselines and the revenue driver be adopted for entry and offtake? What would be the advantages and disadvantages of doing so?*

At this stage it is not possible to make this judgement as the models are not yet established. It is possible that different approaches to baselines could lead to the best solution. What is important is the outcome of the arrangements rather than the arrangements themselves and imposing any artificial constraints on these at this time.

♦ *Should there be one buy-back incentive covering both entry and offtake?*

It is possible that having one incentive could be appropriate at some point in the future once there is experience of any such incentive at offtake.

## **Chapter 8: Incentive options – Electricity**

The document poses two major issues with the current arrangements and then goes on to consider the current arrangements, variants of the current arrangements and finally ‘user-commitment’ models. Our comments follow the structure of Chapter 8.

### Identified Issues with the current arrangements:

- ♦ *Inflexibility of revenue allowances to unanticipated events; and*
- ♦ *Absence of links between demands for future network capacity and revenue allowances – given that capacity at certain points on the network is significantly constrained.*

Inflexibility to Unanticipated Events: Inflexibility to unanticipated events is a relative not absolute problem. The choice of 5-year periods for price controls was an arbitrary but reasonable one that has, in general worked well for the regulated monopolies to date. Over the course of the last price control period, the government’s policy towards and support of renewable generation has changed profoundly and has had and will continue to have a significant and

ongoing impact on the growth of renewable generation. Similarly, implementation of environmental legislation within EU has had and will continue to have a profound effect on the viability of generating technologies. Nevertheless, the government has committed itself to a strategic approach to energy policy (see for example the commitment to 15% renewable generation by 2015 and the ROC arrangement) and a stated desire to let the market be the agent of change. Even with the improvements to the planning system sought by industry, electricity will remain a capital intensive long-term industry with project life cycles in decades. Therefore, we would suggest that the current difficulties in obtaining transmission connection in Scotland may just be that: 'current difficulties', and may not require radical change to the access arrangements. Before radical change is developed there should be a reasonable expectation that the future pace and direction of change will be such as to render the current arrangements, or a variant of them too inflexible to cope with events.

Absence of Links between provision of network capacity and revenue: This argument is frequently found in the preamble for definition of an incentive scheme for a regulated monopoly provider. However, generators who compete for any income in a market view the provision of a regulated rate of return to a monopoly service provider as an appropriate incentive, particularly when combined with a competent regulator and the promise of regular challenging reviews of their performance. Additionally, the possibility of loss of licence, or public censure for a company that has aspirations to continue and expand its operations will act as an incentive. An incentive scheme may allow a regulator to be less intrusive in a monopoly, but from the customer's perspective the regulator enforcing the monopolist's licence obligations may be the cheaper option.

◆ *How can the information available to NGET in respect of demand for network capacity by current and prospective network users be improved?*

The demand for network capacity by current generation users is clearly based on payment process of TNUoS for TEC on an annual basis. Additionally, one type of shorter-term access product currently exists and others can be created within the CUSC arrangements. In recent assessment of further types of access product, it became clear that scope exists for a dialogue between NGET and users in exploring the operational margin for short-term access. Given the long-term nature of generation investments, there should be scope for factoring this information into longer-term transmission planning.

Provision of information under the Seven Year Statement process is a clear means of signalling future expectations of commissioning and decommissioning plant. There may be merit in examining how this may be improved. Parties may be prepared to share confidential commercial information on future plans, provided there are adequate safeguards about its release.

For new development the issue is queue management by NGET that results in appropriate new build of transmission access. Both the developer and NGET are seeking greater certainty. In the first instance we suggest that effort needs to be focussed on improving administrative procedures and possibly a role for the regulator in defining criteria (such as planning consents) as a condition in moving forward in a queue.

◆ *How can the rewards available to the electricity transmission companies be focused on the timely delivery of priority investment?*

A variant of the status quo approach would provide an incentive on all transmission companies to deliver access in a timely way. There may be merit in exploring an option that requires contractual commitment by NGET for commercially firm access, once relevant consents have been gained.

◆ *What should determine the volume of access rights to be released by NGET in the short term – and how should such short term rights be priced or rationed if there are constraints?*

The volume of short-term access rights currently released by NGET is determined by the difference between purchased TEC and the assessment by NGET of any operational headroom. Only NGET are in a position to assess this. Additionally, the possibility exists of TEC trading between generators, facilitated by NGET. Short-term access is specifically designed to avoid enhancing the risk of transmission constraint and should continue to be provided in this way.

◆ *Can the method through which rights are released to the market be improved given potential competing demands for scarce capacity?*

Generators are concerned that the current queue for transmission access in Scotland is clogged by a number of projects that will never materialise. A combination of improved administration using availability of relevant consents as a hurdle, together with firm contractual commitment on both sides needs to be explored.

User Commitment Models: Generators are concerned that the types of user commitment models set out in the consultation will inevitably lead to auctioning of all access. They are not convinced that the processes adopted in the gas transmission area at entry have provided good quality investment signals. It is plain, however, that these processes have led to massive complication of the access provision.

## **Appendix 1 – Consultation on Impact Assessment Approach**

The Association agrees that an option b approach is appropriate with impact assessments being carried out for significant changes that arise from the price control process rather than for the price control as a whole.