Our Ref PD/37.0
Your

Robert Hull
Director, Transmission
Office of Gas and Electricity Markets
9 Millbank
London
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Date 30 January 2006

Dear Robert,

Transmission price control review – Second Consultation

EDF Energy plc is a major UK energy company active in a number of aspects of the UK electricity and gas markets. Among these we are responsible for the operation of power distribution networks, the operation of power stations and the sale to end users of electricity and gas. We are grateful for the opportunity to respond to this consultation and our detailed comments on the proposals are contained in the attachment to this letter

The UK energy industry is entering a period of significant change. The recently published Energy Review consultation recognises that investment in replacing the aging energy infrastructure is a key component of the UK reaching its broader energy goals. Consequently it is vital that the future regulatory framework recognises this and in particular the long term nature of investments in energy infrastructure. We particularly welcome the proposed work on the cost of capital, as this work will have a profound effect on the future financing of the required investment

We are, however, concerned that some of the proposals put forward by Ofgem are overly complex. In our view, the User Commitment models described in the consultation will be more complex and costly to administer relative to the current set of transmission access arrangements in place for gas and electricity. The idea of bidding for transmission access may seem efficient in theory, but there are many reasons, not least the experience of gas entry capacity auctions, that suggest that the User Commitment model represents an inferior solution to refining the current models for gas and electricity transmission access. This approach would seem to align better with Ofgem's stated principle for networks regulation of "applying simple solutions where they are effective".

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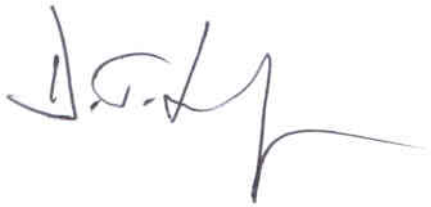
I trust you will find these comments helpful. If you have any queries please do not hesitate to contact me.

Yours sincerely,



Denis Linford
Director of Regulation

Attachment

EDF Energy's detailed comments on the Transmission Price Control Review consultation

1. Framework, context and objectives

We are broadly in agreement with the proposed framework, context and objectives for the review. In particular, we welcome the amendment of the Transmission Price Control Review (TPCR) objectives to explicitly recognise that it is in customers' interests that companies can finance their activities to deliver the outputs important to customers.

However, we believe that there are two key factors which Ofgem need to take into consideration. The first is the impact of the government's Energy Review. This review will have a significant impact on all areas of the energy industry, including both gas and electricity transmission, and hence should be explicitly recognised in the key external factors for the project.

Secondly, the consultation explicitly recognises that the Authority has a duty to discharge its functions in a manner which contributes towards sustainable development. Currently, this duty is framed with respect to environmental obligations. We believe that such an interpretation is too narrow. We are entering a period where significant expenditure is required, over the long term, to both renew and develop the UK's gas and electricity infrastructure. Therefore, it is vital that the framework Ofgem puts in place will facilitate this investment and hence contribute to the sustainable development of energy networks over the long term.

2. Cost Assessment

We support Ofgem's intended approach of utilising a range of techniques, including top down and bottom up approaches, to assess both capital and operating expenditure. The use of bottom up analysis, e.g. functional and/or activity analysis, is particularly important given the limited number of comparators available for top down benchmarking.

We appreciate that the scale of the project will necessitate the use of consultants to undertake some of the assessment work. We would, however, encourage Ofgem to utilise its own internal staff to lead this work as far as is practicable. We believe that such an approach would ensure that the detailed knowledge gained from the review process was maintained within Ofgem. In our opinion this would help reduce the effort associated with an annual cost reporting process.

It is essential that National Grid Electricity Transmission (NGET) is not exposed to unforeseen costs arising out of the review of the Security and Quality of Supply Standards (SQSS). Given that the outcome of this review may not be known for some months we believe that Ofgem should include a limited reopener within NGET's licence to address this issue. This would align with how Ofgem treated anticipated changes in legislation which affected electricity distributors.

3. Form and structure of the price control

We continue to support the use of RPI-X regulation and five year price controls.

3.1. Rolling retention periods

We believe that rolling retention periods are an effective means of reducing the periodicity effects that can occur at the end of the price control periods. If it can be demonstrated that the capital and operating expenditure information is robust, then it would seem appropriate to introduce rolling mechanisms for both capex and opex. An issue that would have to be addressed is the length of the rolling period. Historically, most other regulatory regimes in the UK have used a five year rolling retention period. However, it is now generally recognised that generating operating cost savings is becoming progressively more difficult and expensive. The introduction of a five year rolling incentive for operating expenditure would mean that a company would keep approximately 30%[1]of the value of that saving and consequently customers would keep 70%. As the 30% that companies would be allowed to retain must also cover the implementation costs associated with efficiency initiatives, there is a risk that in the future a number of viable initiatives might not be progressed, as not being cost effective for the company. This is not in customers' best interests. We believe that if a rolling incentive is introduced for opex the period should be extended to 7 years. This would allow the company to retain 38% of the value of any saving. Additionally, if a five year scheme was introduced for capex this would ensure that the incentive power of both schemes is balanced, as a five year rolling period for capex expenditure results in the company retaining 38%[2] of the value of that efficiency. The balancing of incentive power across capex and opex would ensure that the incentive schemes did not inadvertently distort company investment decisions.

We also believe that the rolling mechanism should be symmetrical i.e. apply equally to overspends and underspends. If this were not the case then there would be an asymmetric sharing of risk between customers and shareholders.

3.2. Information quality incentives

We are unconvinced that an information quality (or sliding scale) incentive will add significant value to the TPCR process. The introduction of the capex sliding scale mechanism during the last Distribution Price Control Review (DPCR) was to address issues associated with capex assessment. We did not see it as enduring mechanism. Ofgem's stated intention at the outset of the DPCR process was that it wanted to utilise the company's forecasts wherever practicable. This should be its aim for the TPCR too. Instead of introducing a sliding scale incentive Ofgem should ensure that sufficient resource is devoted to its Asset Risk Management project so that it can more robustly assess the quality of the companies' processes and hence its capital expenditure submission. We support Ofgem's work on refocusing the Asset Risk Management survey and believe it will aid the process of capital expenditure assessment. In our opinion, a sliding scale incentive should be introduced only if this work is unsuccessful.

[1] Assumes operating cost savings are recurring and a discount rate of 7%
[2] Assumes capex cost savings are one off and a discount rate of 7%

3.3. Reopeners

We agree that, where possible, it is better to introduce automatic mechanisms to adjust revenues for unanticipated events rather than reopen the price control. However, we believe that there would be benefit in introducing a specific change of law reopener provision. Changes in legislation are difficult to predict but generally have the most significant impact on a company's operations and hence have the greatest likelihood of requiring the price control to be reopened. The distribution companies presented a proposed licence condition to address this issue during the last DPCR. We would encourage Ofgem to give fresh consideration to it.

4. Incentives.

We agree with Ofgem that recent changes to the Great Britain electricity market have highlighted limitations with the current price control arrangements. However we do not believe that these limitations require wholesale change to the transmission access arrangements to resolve them. Such amendments would far exceed Ofgem's stated desire that any change should be *"focused, proportionate and practicable."*[3]

We believe that there are two key areas where improvements are needed. They are:

- The different approaches taken historically for each of the three Transmission Owners;
- The lack of flexibility within the current electricity Price Controls – there is only a single revenue driver within National Grid's and none for either of the Scottish Transmission Operators (TOs.)

4.1. Revenue Drivers.

An increased use of revenue drivers would solve many of the problems which have arisen during the most recent electricity Price Control periods by allowing the revenues for each TO to vary incrementally in response to unanticipated events. It is important that the same revenue drivers should apply equitably to each TO, but also that they encompass changes to both generation and demand within a defined area.

Of the electricity revenue drivers put forward by Ofgem, we favour the Boundary Flow model, although a different form of locational model could also work. As with the basic revenue driver approach, a locational model would allow revenue flows to respond to developments on the transmission network but the key advantage of this approach is that it would look at generation *and* demand within a defined area.

4.2. User Commitment Options.

The User Commitment models set out in the consultation will be more complex and costly to administer relative to the current set of transmission access arrangements in place for gas and electricity. The idea of bidding for transmission access may seem efficient in theory, but there are many reasons, not least the experience of gas entry capacity auctions, that suggest that the User Commitment model represents an inferior solution to refining the current models for gas and electricity transmission access.

[3] TPCR Second Consultation 8.4.

The gas entry capacity model is widely perceived as having high administration costs and is unduly complicated to the extent that it represents a barrier to entry. In addition there is no evidence of it providing the long-term signals that it was intended to do – shippers are reluctant to buy capacity more than two years in advance because it is impossible to predict the vagaries of the market that far ahead. Where National Grid NTS has undertaken significant reinforcement of its network this has been in anticipation of new interconnectors and LNG import terminals rather than in response to signals emanating from long-term entry capacity auctions.[4] Furthermore the credit cover requirements for longer-term capacity are such that it will only be larger companies who can even contemplate purchasing it.

The current gas ARCA (Advance Reservation of Capacity Agreements) is an alternative model which has produced effective long-term signals for capacity requirements in a simple and cost effective way with minimal implementation costs.

Many of the same limitations would apply equally to a user commitment regime for electricity transmission access and, at a time when security of supply is of overwhelming importance to the entire industry, insecure or semi-permanent access rights can only act as a disincentive to invest in new generation. Transmission Entry Capacity (TEC) may not be perfect but a generator knows that, once provided, access will be available throughout the entire life-span of a power station. Whilst we agree with Ofgem that there is a risk that the cost of stranded assets may be borne by all users of the transmission network, we believe that the actual amount per kW would be relatively minor and certainly a far more manageable risk than those which would occur under a user commitment model. It would be useful and would inform the debate if specific examples of stranded assets could be looked at and quantified in terms of costs on the market.

It is also worthwhile to consider the level of liquidity currently exhibited in the long-term power market; given that power, a far more fungible commodity than transmission access, has not been readily traded in the forward market, it is difficult to see why transmission access should be any different This is more of an issue for exit arrangements as there is invariably only one off-taking party at each exit point and so it is difficult to see how competition for capacity at these sites would increase.

We do not believe that the current gas exit arrangements, which are similar for DNs and DCs (Directly Connected sites), are discriminatory, as we have seen no adverse effects or customer complaints as a result. Rather we believe that some of the more complicated models for bidding for exit capacity that Ofgem has presented would be unduly discriminatory because DNs have linepack and storage within their systems, flow management capabilities and many offtake points that are not available to DCs. If exit arrangements in gas are reformed, different regimes should apply to DNs and DCs to reflect this fundamental difference in the nature of these offtakes.

4.3. System Performance and Reliability.

We believe that NGET should be incentivised to deliver outputs that customers value. However, in order to assess the latter Ofgem should undertake a customer survey to inform its views. This would be consistent with the approach adopted during the

[4] For example, NG Gas has recently significantly reinforced the East to West part of their network in anticipation of new imports through both the BBL and Ormen Lange pipelines due to come on in the next few years. None of these investment signals were generated in an auction. The same applies to the reinforcement of the south-west transmission system in anticipation of new LNG import terminals at Milford Haven.

DPCR. We would expect such a survey to include not only the views of domestic customers but also generators, gas shippers, gas and electricity suppliers, business customers, and gas and electricity distribution network operators.

NGET also faces the same issues as distribution companies in recruiting power engineers. It has been widely recognised that to address this issue careers in the power industry must be made more appealing to young people. We believe that one aspect of achieving such a change in perception would be for Ofgem to establish an Innovation Funding Incentive for NGET. This would consistent with the approach taken at the DPCR.

With regards to System Operator costs and the System Operator Incentive Scheme, we would agree with Ofgem's view that the current arrangements are broadly appropriate, but believe there is a need for improvement in certain areas. The future design of any incentive scheme should focus on areas where NGET can achieve a verifiable cost reduction and that the sharing of both risk and rewards should be symmetrical between customers and shareholders.

In principle, we agree that the duration of the SO Incentive Scheme should match the duration of the Price Control, but this should be the case only once the existing scheme has been refined.

5. Financial Issues

5.1. Financing

Our initial view is that it remains appropriate to determine the ability of a licensee to finance its regulated business by utilising key financial indicators, in order to assess whether the company can maintain an investment grade credit rating. However, we agree that the Ofwat/Ofgem work on the financing of network companies will inform this area and we will review its findings to assess if they provide a better alternative.

5.2. Financial Modelling

We support the proposal to develop a financial model in conjunction with the transmission companies and other interested parties. We agree that transparency of the price control would be improved by publishing the financial model. However, before publishing a fully populated financial model for each licensee we would expect Ofgem to have regard to its duty not to publish information which would prejudice the commercial interests of that company. If the information contained within the model is deemed to be commercially sensitive an alternative approach might to publish an aggregated industry model.

5.3. Cost of Capital

We welcome Ofgem's work on the cost of capital and the opportunity to submit evidence with respect to the appropriate inputs and their estimation. We intend to provide such evidence.

We also believe that Ofgem should determine the final value for the cost of capital in advance of the final proposals in December 2006. While we accept that leaving the decision as late as possible may facilitate the use of the most recent data, this benefit

is outweighed by the regulatory uncertainty it creates. We believe a suitable compromise would be to include a decision on the cost of capital in the September 2006 update.

5.4. Establishing Regulatory Asset Values

We agree that only efficient expenditure should be included in the RAV and that companies must demonstrate why any over or underspend is efficient. However, if Ofgem excludes certain expenditure from the RAV it must set out why it has judged it inefficient. Ofgem's stated position is to include expenditure within the RAV only from the date when it was incurred, assuming it delivers significant customer benefits. We are unsure what is meant by significant customer benefits and believe that Ofgem should set out clearly how it will assess if such benefits have been delivered. Not to do so will increase regulatory uncertainty.

EDF Energy
January 2006