

# National Grid plc Response to Transmission Price Control Review Second Consultation

## Executive Summary

- 1 We welcome the opportunity to comment on Ofgem's second consultation document which seeks views on a number of important policy issues. The structure of our response is as follows:
  - (a) this **executive summary** highlighting the key areas upon which we believe policy decisions are required in order to further develop the **form of control**;
  - (b) a paper covering a more **detailed response** on the issues and questions raised in the individual chapters of the consultation document; and
  - (c) a paper on **pensions** which highlights our views on the key areas relating to pensions to be resolved during the TPCR process.
- 2 We believe the outcome of the consultation on the form of control and pensions will be key elements in the final proposals and therefore we welcome the early discussion on these elements and look forward to working with Ofgem to develop appropriate policies in these two key areas.
- 3 In terms of overall context for the transmission price review, we are pleased that Ofgem recognise in their own summary that transmission networks play a key role in facilitating the competitive electricity and gas markets in Great Britain, and timely investment in the networks is essential to ensure their efficient operation. We believe that the link between timely investment in transmission networks and the efficient operation of the competitive electricity and gas markets in Great Britain is important. Therefore, we fully support Ofgem's view that a key focus for the review will be to develop the correct incentives for investment in gas and electricity infrastructure, ensuring they are best able to promote efficient and timely investment and allocating risk appropriately.
- 4 With this in mind, we believe that Ofgem need to consider whether any of the models (e.g. a **pure** user commitment model) contained in the consultation document are more likely to lead to under-investment in the transmission system. We would note and agree with the risks Ofgem have identified regarding too little investment (or investment incurred too late) within Chapter 6 and the significant risks this can carry for consumers. As noted in Chapter 6, at the extreme, transmission constraints could potentially place strains on security of supply. However, a less dramatic – but very important – risk is that network constraints create unnecessary delays to new market entry, and result in higher prices for consumers. Focused and timely investment is therefore critical to the interests of consumers.
- 5 We would also agree that the main purpose of the TPCR process is to ensure that the revenues that the transmission companies can earn are structured in a manner consistent with protecting the interests of consumers and also ensure the licensees can finance their licence and statutory obligations. We believe, in the context of this transmission price control review, that it will be crucial to consider both the obligations and remuneration of National Grid in parallel to ensure they are aligned. We believe obtaining clarity on National Grid's obligations in relation to capital investment is particularly important in the context of the user commitment models upon which Ofgem are consulting. The key policy questions relate to:

- (a) obtaining clarity on National Grid's obligations to invest under a User commitment model; and
- (b) the intended remuneration mechanisms under a user commitment model, in particular the use of revenue drivers to deal with uncertainty during the price control period.

These are set out below.

### Clarity on obligations to invest

- 6 We believe that the interaction between the statutory obligation to develop and maintain an efficient and economical pipe-line system for the conveyance of gas and any user commitment model needs clarifying in gas and would need considering in advance of developing any similar user commitment model in electricity. Whilst we believe that the current gas entry regime has positive characteristics in the manner in which it has enabled revenues to adjust to cater for new investments which are required but were not foreseen at the time of the last price review, we believe that there is scope for uncertainty regarding National Grid's obligations to invest when user commitment is **not** forthcoming. In clarifying National Grid's obligations, there should be a clear understanding of how National Grid is then remunerated to meet those obligations.
- 7 The need to clarify the interaction between obligations, user commitment and remuneration is best highlighted by the two separate paragraphs from the consultation document detailed below:
  - (a) Paragraph 6.7 (the description of the User commitment model) refers to "a regulated revenue stream where allowances for additional investment **are contingent on commitments** by network users, and where there are explicit risk-sharing arrangements defined as part of the package of incentives."
  - (b) Paragraph 7.13 states "Users buy, or make firm financial commitment towards, what they think they will need in advance, and National Grid NTS plan the network on the basis of these bookings (**and all other relevant information**).
- 8 These two paragraphs lie at the heart of the need to gain clarity between obligations, user commitment models and remuneration. Paragraph 7.13 implies that, in planning the network, we should take into account user bookings **and** all other relevant information. This would seem consistent with National Grid continuing to have obligations that are broader than merely planning the system solely on the basis of user commitments. If this is the case, then there would appear to be an inconsistency in terms of remuneration, as paragraph 6.7 implies that additional revenue is only forthcoming for investments which are supported by user commitment. We are therefore keen to understand how we would be remunerated for necessary investment (i.e. based on our broader obligations) where there is no user commitment.
- 9 Although we believe clarity is required in relation to the existing gas entry model, we believe it is even more crucial in the context of adopting a user commitment model in gas exit and electricity. In relation to gas exit, the NTS currently has a 1 in 20 obligation which also forms part of the Safety case. We are therefore obliged, with or without user commitment, to build the network to be compliant with our 1 in 20 obligation. Given the definition used in relation to the user commitment model in paragraph 6.7, it is necessary to be clear how National Grid would be remunerated for investing to meet the 1 in 20

obligation if that was **not** supported by a user commitment. The same issue would also apply to electricity, given the licence obligation to invest to meet the security standards.

- 10 Based on the premise that obligations and remuneration should be aligned, there would appear to be two potential options available in the context of the user commitment models:
- (a) Amend the obligations on National Grid such that the obligations are met by only responding to user commitments. Using gas exit as an example, this would mean changing the current 1 in 20 obligation on the NTS to state that the obligation was met by responding to user commitments from the DNs, which should in turn match the DN's 1 in 20 obligation.
  - (b) Ensure that a mechanism exists for revenue to adjust to cater for new investments which are required but were not foreseen at the price control. This would not solely link the revenue driver to investments that were triggered from user commitments.

- 11 The potential use of revenue drivers is considered in the section below:

### **Revenue Drivers**

- 12 As mentioned in our response to the initial consultation, we are supportive of the use of revenue drivers as part of the overall package of revenue mechanisms to be agreed as part of the price control. We can see the benefit of using revenue drivers to supplement the main price review allowances where there is uncertainty whether investment is going to be required within the price control period.
- 13 We are keen to work with Ofgem over the coming months to develop cost reflective revenue drivers. We are currently doing work to determine whether it will be possible to develop revenue drivers to meet the high level objective of adjusting revenue within a price control for investments which were not provided for in the main price control. However our work to date would suggest that it will be difficult to design accurate revenue drivers and therefore we would currently see the revenue drivers as effectively being a "down payment" for necessary investments during the price control period. In the event that the revenue drivers had provided insufficient remuneration (or too much) we believe this should be adjusted as part of the next price control such that the transmission company was left whole. The open letter published by Ofgem<sup>1</sup> setting out the principles it intended applying in assessing past capital expenditure in excess of allowances would seem to be an appropriate mechanism for doing this. Based on the likely inaccuracies of revenue drivers, we would currently **not** support the 5 year rolling incentive mechanism contained in the consultation document, not least because such a mechanism would be unable to distinguish between variations in capex due to inefficiency and variations due to unanticipated requirements to spend.
- 14 In summary, we believe that, in this transmission price control review, it will be crucial to consider both the obligations and remuneration of National Grid in parallel to ensure they are aligned. We believe obtaining clarity on National Grid's obligations in relation to capital investment is particularly important in the context of the user commitment models on which Ofgem are consulting. Having obtained clarity on National Grid's obligations, it will then be necessary to consider the methods by which National Grid is remunerated for meeting those obligations.

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<sup>1</sup> Open letter on Gas Distribution Price Controls, Ofgem, 16 March 2004

- 15 With this in mind, we believe that Ofgem, in developing policies on the form of control, should consider the following questions:
- (a) Should obligations and remuneration be aligned as part of the TPCR process?
  - (b) Should National Grid **only** be remunerated, during a price control period, for load related investments (above baseline) which are backed by a financial User commitment?
  - (c) If the answer to (b) is yes, but National Grid still has broader licence obligations which can require investment, how does this meet a principle of aligning obligations and remuneration (i.e. Question (a))?
  - (d) If the answer to (b) is no, how would National Grid be remunerated for necessary investments (such as meeting the 1 in 20 obligation) which are not backed by financial user commitment?
- 16 In relation to the above questions, we believe that obligations and remuneration need to be aligned as part of the TPCR process. Although we can see some merit in the use of user commitment, we would **not** advocate a model where by National Grid is **only** remunerated, during a price control period, for load related investments (above baseline) which are backed by a financial user commitment. We would therefore see investments backed up by user commitment being a sufficient, rather than a necessary, trigger for investment. On this basis, a revenue mechanism other than user commitment needs to be agreed for investments that are driven by the requirements of our broader licence obligation. Revenue drivers may therefore need to be linked to an output measure such as additional capacity released or additional km of pipes or wires, rather than purely to the existence of a user commitment. Such a model, when considered in conjunction with the overall concept of the revenue drivers acting as effectively a "down payment" for necessary investment during the price control period, which would be adjusted as part of the next price control such that the transmission company was left whole, would seem the best way of dealing with the uncertainties over the price control period.
- 17 The regime outlined in paragraph 16 above would seem a sensible way of dealing with the uncertainties associated with load related investments. We would, however, agree with Ofgem that there is still a key role for the traditional TO price control to consider non load related revenue and also to establish a baseline for load related investment.
- 18 Developing revenue drivers which are not dependent upon the introduction of a new user commitment model would appear to be the only sensible option, given user commitment models in electricity and gas exit would still require implementing through changes to the commercial framework. It would seem that decoupling regulatory revenue drivers and baselines from the commercial framework is necessary to allow the flexibility to ensure a price control settlement could be agreed, by the end of 2006, whilst allowing the optimum time to consider and introduce changes to the commercial framework.
- 19 In the attached paper, we elaborate on the issues contained in this Executive Summary. We have paid particular attention to the issues and questions raised in Chapters 6, 7 and 8 of Ofgem's Consultation Document, which cover both price control aspects and potential reform to the wider commercial framework. Given the range of issues covered in these chapters, we believe that it is inevitable that further dialogue will be required between now and the publication of the third consultation document in March, in order to reduce the number of options into a set of potential proposals to develop further as part of the price control.