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Dear Mr Hull

Second Consultation: Transmission Price Control Review

Comments

energywatch welcomes the opportunity to consider the issues raised by this second consultation paper. Our comments reflect the issues arising in each of the chapters in the paper.

We note the consultation timetable for the Review and look forward to contributing at each stage of the development of the proposals. We also note and support the use of workshops and seminars to develop these proposals so as to allow all stakeholders to focus on the key areas of the Review. It would be helpful for Ofgem to publish a preliminary Impact Assessment at the third consultation stage, as the underlying policy framework will have begun to take shape by then. It would also be desirable to have a final Impact Assessment towards the end of the Review. Where significant issues arise which affect the outcomes of the Review, it would be helpful for Ofgem to issue an Impact Assessment at those times, although this must be balanced against the danger of information overload.

We recognise the impact of changes to market structure and environmental factors on the design of the price controls to apply to gas and electricity networks from 1 April 2007. The outcome of the Government's Energy Review is also likely to have a significant effect on the desire for, and location of, investment on the networks by the transmission companies. We agree with Ofgem that any decisions on the design of the controls must be made within the overall framework of the objectives of the Review which should align with the Authority's legal duties and which include **the protection of the interests of consumers**. Consumers have an expectation that investment in networks will be carried out efficiently, that the networks will be operated efficiently and economically, and that security of supply will be delivered as a result. If cost savings are made, these should be shared with all consumers.

We have no specific comments on the basis for cost assessment of the expenditures required under the price control. However, we consider that a suitable baseline for

capital expenditure should be determined early in the process and in depth, and that there should be transparency regarding how the amounts are arrived at. The price control mechanism should be flexible enough to allow for adjustment of price control allowances but adjustments should be allowed only where these can be fully justified in terms of efficient investment and are verifiable as such. We agree that the adjustment of the price control formula for transmission investment in renewable generation (TIRG) was a one-off and should not be made part of the main enduring price control. In any case, our view of TIRG remains that this should not be part of the price control and should be recoverable, as a social benefit, from all taxpayers rather than electricity consumers alone.

We would reiterate our view that any savings from operating expenditure should be shared with consumers. National Grid has outlined that savings have been made following the corporate restructuring of its gas and electricity businesses but no mention has been made of savings derived from the sale of the gas distribution networks. We look forward to National Grid's assessment of the cost savings which it is likely to obtain from these sales and how it intends to share these benefits with consumers. We would also note in passing that a full assessment of further efficiency savings is required where economies of scale arise from the interaction between the system operation function of National Grid and the transmission operator functions of National Grid, Scottish Power and Scottish Hydro Electric.

We reiterate our support for continuing the RPI-X formula as the basis for price controls going forward. We also maintain support for a five-year price control to ensure that the investment period remains meaningful for network operators. The formula has generally worked in terms of reducing costs and provides an element of stability to the calculation of allowable revenues. Further enhancements to the formula would be welcome as this adds flexibility, given the uncertainties surrounding some areas of investment over the next price control period. However, we are against re-openers as these may create instability around allowable revenues and are not fully convinced of the application of revenue drivers. There does need to be a comprehensive and transparent assessment of investment needs for the networks upon which to formulate the initial baseline and then flex it, where this is justified on grounds of cost efficiency and economy. This assessment should also cover sliding scale incentives and any other incentives identified which may lead to cost efficient and economic operation.

We note and support the emphasis on protecting the interests of consumers when assessing appropriate design options for the price control. It is particularly important that sufficient investment is made to operate networks efficiently and economically. It is not incompatible with this aim to develop controls which promote competition (and should help to reduce costs), and which are simple and transparent, generally stable and enhance security of supply. We also agree that implementation costs should be minimised. It may be instructive for Ofgem to consider the cost/benefit position from the perspective of consumers to assess whether the balance of risk allocation is fair between all parties when constructing an appropriate price control model.

We have not fully assessed the implications of the options for the gas price control incentives and whether a locational element to the entry and offtake incentives is

appropriate or not. Baseline capacity should be determined through a comprehensive assessment of existing and proposed known user requirements over the five-year period of the control, with incentives for incremental capacity being added where identified as being cost efficient. We consider that the provision of incremental capacity is probably best recovered from those users who seek this capacity and that there should be direct cost attribution to these parties through contracts with the network operator. If they subsequently fail to use the booked capacity, there should be appropriate penalties in place to recover the costs of potential stranded assets, as well as a right given to the operator to buy back the capacity and sell this on to another interested party. Allowance needs to be made for multiple-year capacity booking where this is agreed between user and operator to be firm, and the associated incentives should reflect this arrangement. We hope to use the proposed workshops to better understand the implications of locational, as opposed to global, incentive options for the price control design.

As with gas price control incentives options, we are continuing to study the implications of the design of electricity price control incentives. We have already noted that revenue drivers need to be fully assessed, preferably from the point of view of the fairness of allocation of cost/benefit (and, therefore, risk) between parties. We will consider further the effects of locational incentive options compared to global incentivisation. However, we note that there will be implementation issues depending upon the option which is adopted, including modifications to various codes and other documents. The cost implications will need to be assessed as part of the overall package that is adopted.

We note Ofgem's view that the incentive models adopted for gas and electricity networks will seek to achieve cost savings and that these should be shared as appropriate with consumers. We would request Ofgem to be mindful of the possible cost savings arising from operational economies of scale as well as savings arising from interaction between gas and electricity network operation but only where this gives rise to efficient and economic operation of each network. We would also request that there is transparency in the assessment of the financial implications of adopting any proposed models. We note that Ofgem intends to hold a workshop on the financial model and we would like to express our interest in such an event.

Going forward, we will continue to keep these issues under review throughout the remainder of the Price Control development process as and when they are raised, always considering the possible impact on consumers.

We would appreciate being kept informed of the progress of the consultation and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley

Head of Regulatory Affairs