

PD/37.0

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1 March 2006

Dear Robert

Transmission Price Control Review (TPCR): Capital Expenditure Projections 2007–2012

Thank you for the opportunity to respond to this consultation.

It is clear that the transmission companies are embarking on significant levels of both reinforcement and asset replacement expenditure over the next price control period. Given that these new assets will, like their predecessors, have an expected working life of possibly fifty years or more, it is essential that the regulatory decisions are conducive to the efficient and effective delivery of the asset infrastructure needed by 21st century energy markets and policies.

We recognise that there is considerable uncertainty regarding both future network architectures and the development of different patterns of generation. Consequently, it is vital that the regulatory framework developed to facilitate this new investment:

- is flexible enough to deal with this uncertainty; and
- takes into account the long term nature of these investments.

We believe that there is a very real once-in-a-lifetime opportunity to match new network technologies with new patterns of electricity generation and gas entry. The government's energy policy review is determining the appropriate policy frameworks and goals for the long term. It is vital that the regulatory framework that Ofgem puts in place is aligned with the output of this review.

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A key component of the current regulatory framework is the process by which capital expenditure is added to the regulatory asset value (RAV). Ofgem's stated position is to include expenditure within the RAV, from the date when it was incurred, only if it delivers significant customer benefits. We are unsure what is meant by this 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.

The consultation also correctly highlights that the financing of this level of capital expenditure will be a significant challenge. In addition, it must be remembered that there is significant required investment across Europe in upgrading energy infrastructures. There will therefore be significant global competition for capital and it is imperative that this is recognised when Ofgem is developing its views on the appropriate cost of capital.

We support the use of incentive mechanisms to encourage efficient capital expenditure. However, when Ofgem is developing such mechanisms it should take into account the degree of uncertainty associated with the expenditure. As there is considerable uncertainty over the level of capital expenditure to facilitate renewable generation, the incentive mechanism should ensure that:

- customers are not exposed to the companies making windfall gains; and
- companies are not exposed to losses due to circumstances beyond their direct control.

However, given that Ofgem (or its consultants) should be able to assess the robustness of both the general reinforcement and the asset replacement expenditure forecasts, we believe that the application of a rolling incentive mechanism, similar to that applied to the distribution companies, is appropriate. In addition, we would encourage Ofgem to use its own internal staff to lead this assessment work as far as is practicable. We believe that such an approach would ensure that the detailed knowledge gained from the review process is maintained within Ofgem. This would help reduce the effort associated with an annual cost reporting process.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford', with a long, sweeping horizontal stroke extending to the right.

Denis Linford
Director of Regulation