

Ofgem open letter on Transmission Price Control Review (TPCR) capital expenditure projections 2007-2012

Response by National Grid

- 1 Ofgem's Open Letter of 1 February contains the following main elements:
 - (a) a summary of the capex projections submitted to Ofgem, as part of the TPCR, by National Grid Electricity Transmission (NGET), National Grid Gas (NGG), SP Transmission limited (SPTL) and Scottish Hydro-Electric Transmission Limited (SHETL) – and the placing of these projection in the context of past spend by the licensees and of the existing regulatory asset bases (RABs);
 - (b) re-iteration of Ofgem's aim to put in place a regulatory framework to encourage the delivery of efficient and timely investment, with an important part of that framework being the signalling by network users of their commitment to use incremental capacity;
 - (c) an invitation for responses to the above and, in addition, to the following specific questions:
 - (i) Are there any further factors that should be taken into account in the TPCR given the potential scale and uncertainty of forecast capital expenditure?
 - (ii) What other factors, or alternative approaches, should Ofgem take into account in designing the incentive framework to ensure that transmission companies finance their capital investment plans in a timely and efficient manner, and serving the interests of consumers?
 - (iii) How might Ofgem address the issue of fully depreciated pre-Vesting assets to ensure that they are replaced according to need rather than to replace lost value.

- 2 Each of the above is discussed below.

Capex projections in the context of past spend and of current RAB values

- 3 Ofgem point out that the capex projections for the next price control period are high in relation to both:
 - (a) actual spend in the current price control period; and
 - (b) current transmission RAB values.
- 4 Although a great deal of information, especially information about the condition of our assets, is being provided to Ofgem to justify our projections, two points are particularly worth noting in relation to (a) and (b) above:
 - (a) A significant part of the projected increase results from actual or expected demand from network users for increased network capability. Of our proposed spend on the electricity network from April 2007, around 36% is load-related spend. The equivalent figure for the gas transmission network is

around 64%. In turn, the overwhelming bulk of the projected load-related **gas** transmission spend is directly linked to the user commitments, represented by network users' bids in the long term entry capacity auctions or by other forms of contractual commitment. As far as load-related investment on the **electricity** transmission network is concerned, Ofgem is in the process of formulating what form it would like user commitments to take (see below on designing the incentive framework) – but, in any event, it is likely that we will only be spending (and will only be remunerated for spending) on assets which customers will have shown that they want, albeit that this begs the question of the treatment of system reinforcement which is not directly linked to particular user commitments.

- (b) Especially in relation to **projected capital spend in relation to current RAB values**, it is worth noting that, although this ratio is important in understanding what may happen to transmission prices over the next price control period, **the ratios should not be interpreted as a measure of the size of the proposed asset replacement programme in relation to the existing transmission systems**. To get some feel for this latter, the relevant ratio would be the ratio between proposed **asset replacement** capex and the gross current replacement cost for the existing system. In this context, it is worth noting that, although National Grid no longer formally records replacement cost (or current cost) values in its accounts, the gross replacement cost for the **electricity** transmission system (excluding the cost of replacing towers on the grounds that we are expected to incur virtually no capex in this area in the forthcoming price control period) is around £15.5 billion. In other words, the proposed spend of £2.5 billion in the next price control period is around 16% of the total replacement value (excluding towers).

'Other' factors which should be taken into account in the TPCR

- 5 We believe that this question is addressed primarily to stakeholders other than the transmission companies. However, it may be worth pointing out that, although (as is clear from the documents already published as part of the TPCR) the bulk of the proposed network investment is either (a) spend to meet specific customer requirements or (b) spend to replace existing assets in the light of the condition of those existing assets, a significant part of the proposed load-related spend on the electricity transmission system is to accommodate changing patterns of generation which are, in turn, seen as an integral part of the government meeting its broader environmental/climate change targets for the energy sector.

Designing the incentive framework for network investment

- 6 As in the most recent consultation document on the transmission price reviews, Ofgem notes the importance of investment being efficient and timely. Ofgem's current thinking on encouraging this, as spelled out in its Second Consultation Document¹ and as echoed in the Open Letter, comprises the following two key elements:
 - (a) the need for signals of 'user commitment' to trigger the investment to enhance the capability of the transmission system (LRE spend in the Open Letter); and
 - (b) the need for "revenue drivers and other mechanisms to provide additional revenues to finance incremental investment as it is needed".

¹ Ofgem, Transmission price control review, Second consultation, December 2005

- 7 On this basis, it is likely that, although it is for discussion as to how much of the projected investment is initially remunerated through the basic TO price control and how much through ancillary mechanisms, a proportion of the proposed capital spend will probably not be included in the basic TO price control revenue but will, instead, be triggered as and when the requisite user commitment is forthcoming.
- 8 We agree that user commitment, and the information which it will hopefully provide about future use of the transmission system, should be a key element in driving load-related capital spend on the transmission networks. However, there is an important issue about whether such commitment should be the **only** trigger of such spend. In particular, it is for consideration whether having user commitment as the only trigger would tend to cause network investment to be systematically **untimely** (i.e. late in relation to what users want). This might happen because:
- (a) Network users will typically have to go through several project stages, including the securing of consents and financing, **before** they are prepared to commit to paying for network enhancements/extensions.
 - (b) Having user commitment as a necessary condition for load-related network investment to take place would, **at least in a 'vanilla' user commitment world**, mean that all the key stages for a typical network investment project (including environmental assessment and the consents process) would **start** only **after** user commitment had happened.
 - (c) The result of (a) and (b), taken together, would be that, unless the network users' own construction process is going to take rather a long time (and many renewables projects can be constructed in a matter of months), the network infrastructure would typically be ready only some time after the user wished to connect to the transmission network (and maybe after overall security of supply would require), largely because processes which might otherwise run in parallel would typically be sequential.
- 9 There are, however, various ways in which the above chain of events could be avoided, or at least mitigated, even within the overall user commitment framework, and we look forward to discussing these with Ofgem as part of the TPCR process.

Asset replacement and the depreciation of pre-Vesting assets

- 10 Ofgem asks how it might "address the issue of fully depreciated pre-Vesting assets to ensure that they are replaced according to need rather than to replace lost value". We find this a particularly odd question. A very large proportion of the effort currently being invested in the current review process is being spent on reviewing the asset condition case for replacing assets. This is a large part of what any network price review is, and should be, about. At the end of this process, Ofgem will come to a view as to whether the information presented by companies is adequate - both information about the condition of assets and, even more, information about the processes by which network companies judge assets to be in need of replacement. This will then inform Ofgem's proposals as to what revenue the transmission network companies should receive through the next price control period.
- 11 Against this background, it is not obvious what the relevance is of the fact that, within a few years, pre-Vesting transmission assets will be full depreciated for regulated revenue purposes. This is clearly an issue for Ofgem in performing its **financeability** tests - and it is clearly for Ofgem to decide whether, as with the DNOs, it will propose, for example, a shortening of the regulatory lives of post-Vesting assets as a way of **profiling** future regulated revenue. It is not clear to us what relevance all of this has to the assessment of the condition of existing network assets and of the need for their replacement. For the avoidance of doubt, our projections of required spend on asset

replacement are based on the condition of the existing assets and the objective of maintaining overall system reliability – and have no linkage to the profile of regulatory depreciation or the regulatory value of those assets.

National Grid
1 March 2006