

Date: 27th April 2006

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Dear Robert

TRANSMISSION PRICE CONTROL REVIEW – THIRD CONSULTATION

Thank you for the opportunity to comment on the issues raised by the above consultation as issued in March 2006.

This response is made by British Energy Group plc. British Energy is the UK's largest generator of electricity. We own and operate eight nuclear power stations as well as Eggborough Power Station, (a large coal plant with two units fitted with FGD) and four small, embedded gas generator sites. British Energy Direct is a large supplier selling exclusively to Industrial & Commercial customers accounting for around 30 TWh of the UK supply. The views expressed below predominantly relate to the electricity transmission price controls.

Key Points:

The existing form of price control has proved to be successful in past controls and continues to have a role to play now. However, the present uncertainties facing the electricity market due to the impact of renewables, the interpretation of the LCPD, emissions trading and the recently commenced energy review creates a need for a more flexible regulatory framework for the three transmission licensees. Such flexibility will significantly reduce the likelihood of the need to re-open price controls to accommodate unanticipated developments.

Rolling incentives can address the periodic nature of the present arrangements by ensuring that the transmission licensee(s) bear (or keeps) the difference between allowances and actual costs for a fixed period of time. We consider that such an approach will introduce more flexibility and help encourage more innovative efficiency savings.

We agree that the present transmission access arrangements need review and possible change and have actively participated in the Access Reform Options Development Group (ARODG). In principle we are supportive of the creation of longer term finite access rights provided we are able to agree fixed tariffs for the period in question and most importantly are given first rights of renewal at the end of the period at the pre-existing TEC value.



Consultation Questions

Form and Structure of the Price Control

Do you think the standard RPI-X framework needs to be refined or augmented in its application to the transmission licensees?

Yes, the standard RPI-X price control framework has worked well and has delivered benefits to customers since its introduction. However the present uncertainties noted above and the effective re-opening of the present price control to accommodate renewable developments means that refinements are necessary.

Do you think that rolling incentive mechanisms are the most appropriate way to deliver a consistent strength of incentives over time, and do you think they are applicable to transmission licensees?

Rolling incentives can address the periodic nature of the present arrangements by ensuring that the transmission licensee(s) bear (or keeps) the difference between allowances and actual costs for a fixed period of time. We consider that such an approach will introduce more flexibility and help encourage more innovative efficiency savings. We therefore think that such an approach could be applicable to the transmission licensees as long as Ofgem can provide evidence that this approach to incentives setting has worked well thus far under the Distribution Price Controls.

Given the large bids made by some licensees for asset replacement expenditure how do you think the regulatory regime should look? Do you think that an “information quality incentive mechanism” is the best way to improve our information on efficient costs, by rewarding licensees more if they accept more challenging cost targets?

All electricity transmission licensees have signalled a significant increase in capex requirements ranging from 161% for NGET to 1057% for SHETL. As Ofgem note in the consultation paper the licensees will always have better information hence the potential for allowances to be too generous clearly exists. In our opinion Ofgem needs to consider this issue further rather than introduce another incentive scheme. Licence obligations provide strong incentives on licensees and these should be used to ensure accurate expenditure forecasts are provided.

Ofgem need to understand and be able to scrutinise and challenge licensee forecast expenditure. There is no effective substitute for thorough independent scrutiny of the capex programmes proposed, and for ongoing monitoring of the ability of the licensee to deliver the benefits that the approved expenditure is intended for.

A key element of the new transmission licensee regulatory regime will be the introduction of revenue drivers. This approach, rather than more incentive schemes, should ensure that the large capex requests can be sub-divided and ensure that allowed revenue targets only increase in response to certain pre-agreed conditions being satisfied. Clearly the setting of these revenue drivers will be a key part of the present TPCR.

Are additional measures needed to promote innovation? What is the scope for innovation by transmission licensees to benefit consumers?

The use of rolling incentives and revenue drivers will provide a significant opportunity for more innovation compared with the present price controls. In setting a price control a balance needs to be struck in terms of the length of the control between the need to maintain incentives and concerns over volatility and accuracy of forecasts. We consider that the present 5 year period remains appropriate.



The possible use of differential rates of return would rely on the level of understanding and certainty Ofgem has of costs in a specific area. On balance we tend to the view that the application of a standard rate of return remains appropriate for the next review period.

Should the current form and scope of System Operator (SO) incentive schemes be adopted in the next price control period?

The existing form of and scope of SO incentive has generally worked well and remains appropriate albeit that until recently it tended to over reward NGET. We would support an SO incentive scheme which was set for a period greater than the present one year as this should encourage further potentially significant efficiency improvements which have payback periods greater than a year. Given recent developments and uncertainties we recognise that it may prove difficult to achieve while maintaining challenging targets but consider this should nonetheless be a key part of Ofgem's strategy for SO incentives.

To what extent should incentives applying to Transmission Owner (TO) costs and SO internal costs be equalised? Should these costs (e.g. staff costs and IT spend) form part of the TO price control?

We consider that the present arrangements which provide transparency of SO internal costs are useful to users and should prove of value to Ofgem in any benchmarking of NGET's performance in undertaking this important activity. We therefore consider that the existing arrangements should continue from a TPCR perspective.

Electricity Incentives

Do you agree with our conclusion that the use of locational revenue drivers is the most appropriate way to set allowances for the electricity transmission licensees in the context of significant uncertainty over the future demand (and location of that demand) for network capacity?

We support the use of revenue drivers which would allow uncertain or unanticipated developments to be captured within a price control. This should provide end customers and users with additional protection against the funding of expenditure that does not happen if forecasts are too generous. It should also help reduce the likelihood of re-opening the price control. Clearly the setting of the baseline and specific revenue drivers will be a key aspect of the present TPCR.

The introduction of locational revenue drivers would recognise the difference in costs of infrastructure developments in different locations. This should provide a more transparent and detailed view of allowed revenues. The identification of the relevant zones or boundary flows will also be a matter for consideration under the TPCR.

What factors should we bear in mind in drawing the boundary between fixed baseline revenue allowances and variable revenue allowances to be set through the revenue drivers?

This is a complex and key area which is difficult for users to comment upon in any detail, however, at a high level the baseline allowances should include the no-load capex related expenditure as there is likely to be more certainty and the traditional RPI – X form of regulation seems most appropriate. Load related capex being less certain should be the subject of the revenue drivers.

When should we supplement the revenue drivers with other mechanisms to top-up revenue allowances in exceptional circumstances where major investment is needed? How might these other mechanisms work?

The occurrence of exceptional unforeseen large infrastructure developments will be far less likely under a price control regime which includes the use of revenue drivers. Were such an unanticipated



event to occur then Ofgem would need to undertake a thorough impact assessment and consultation with users before any adjustments to regulated revenues can take place i.e. it will need to be treated as a price control re-opener. We don't consider there to be any alternative to this approach, but there needs to be arrangements/incentives in place to reduce the risk of the transmission licensee having to bring forward major new infrastructure requirements which were not anticipated when the price control was set.

Do you agree that, in the current market context, it is important to explore options to change transmission access arrangements? Do you agree with the process we have set out to progress this work?

Yes, as stated above we agree that the present transmission access arrangements need review and possible change and have actively participated in the Access Reform Options Development Group (ARODG). In principle we are supportive of the creation of longer term finite access rights provided we are able to agree fixed tariffs for the period in question and most importantly are given first rights of renewal at the end of this period at the pre-existing TEC value.

System Reliability Incentives

We are not convinced that this scheme is necessary. Licence obligations should provide the necessary framework for assessing NGET's performance. In this context a 'penalties only' scheme should be adopted.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Capener', with a horizontal line underneath.

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