



CHEMICAL INDUSTRIES
ASSOCIATION

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TCPR 2007-2012: 3RD CONSULTATION

Robert

The CIA welcomes the opportunity to respond to this important consultation. Looking forward the CIA recognises the requirement to connect renewable generators in Scotland combined with the need to replace ageing assets and accommodate changing flows of gas within the system. In response to Ofgem's specific questions the CIA would make the following observations:

Question 2.1: Do you think the standard RPI-X framework needs to be refined or augmented in its application to the transmission licensees?

The CIA recognises that historically the RPI-X methodology appears to have delivered an economic and efficient transmission system, whilst allowing the transmission companies sufficient returns to continue to fund their business. The CIA does however believe that whilst the basis of this regime is sound there are minor improvements that could be made to overcome some of the current discrepancies (see response to Q2.2)

Question 2.2: 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?

The CIA believes that transmission companies should be incentivised to deliver investment over the entire period of a price control and not just at the start. We therefore support the application of rolling incentives and believe that they are applicable to transmission licensees.

Question 2.3: 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 if they accept more challenging cost targets?

The CIA would note that one of the hardest elements of any price control is deciding what represents challenging cost targets and what does not. The CIA recognises the benefits of an information quality incentive mechanism provided that the base target is sufficiently challenging.

Question 3.1: 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 for the network capacity?

The CIA believes that the cost of connecting generation to the network will be locationally sensitive and therefore recognise the benefits of adopting such an approach, and that this will help to protect customers. We would however urge Ofgem to ensure that such an approach will be adequate in the majority of likely foreseeable scenarios. In particular the CIA would urge Ofgem to adopt an approach that would provide a cost reflective mechanism for connecting offshore wind farms to the system.

Question 3.4: 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 CIA would note that the presence of exceptional items in company accounts, suggest that certain circumstances need to be treated specially. We would further note that planning for exceptional circumstances in their own right is a very difficult task; if you were able to plan for them they would not be exceptional. The CIA would therefore note that in exceptional circumstances where significant investment is required it may be acceptable to re-open the price controls to accommodate this. This would provide the TO with the confidence



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that they will be able to recover revenue for exceptional circumstances provided the investment required was economic and efficient, whilst providing the market with assurance that Ofgem had scrutinised this type of investment sufficiently, and that it was economic and efficient.

Question 3.5: 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?

The CIA recognises that the current system for applying for access is a relatively costless exercise for the applicant, and this causes delays and costs to NGET, and we further recognise the desirability of applying a stable financial commitment from generators who require access to the network. We would however question whether it is equitable, and in the consumers interest to move some of the risk from generators onto consumers in the construction phase. We believe that an application fee associated with an application for TEC might reduce the number of speculative applications, thereby reducing costs to NGET and delays in providing access. This fee could then be deducted from the FSL paid by the potential connectee in order to maintain the current situation. We would further question how reducing the financial commitment for access to the electricity system fits with proposals to introduce a financial commitment for use of the gas system?

Question 5.1: Is our approach for the transitional period appropriate?

The transitional period allows our members to continue as before with prevailing rights to NTS Exit Capacity. Our members are discussing the proposed nodal baselines determined from practical maximum physical capacity and will we respond to these values through the impact assessment due to close out in mid May 2006. We support the changes to the incentives as proposed by Ofgem.

Question 5.2, 5.3 and 5.4:

Industrial loads normally have a relatively flat profile compared to GDNs or power stations. We consider the current regime works well, and would require evidence to justify change. The current proposals appear to make all sites firm, and we believe that interruption is required on the system to help the NEC in stage one of an emergency. We would also like to know if TCCs could be given the option to purchase their own NTS exit capacity should they wish to. Finally, we don't believe that the case for change has been made, and we would stress that it is very difficult for chemical sites to predict how they will operate in the future.

Question 5.5: Are the proposals for a gas offtake buy back incentive appropriate?

We agree that the costs of buy backs are for NG and should not be passed on to customers.

Question 8.2: How should we approach our assumptions for the cost of debt? Should we use medium term historical averages?

The CIA welcomes the work being undertaken by consultants on behalf of Ofgem. The CIA would note that the benefit of taking of a medium term historical average cost of debt may help to overcome any short-term volatility in these markets, but we would also note that such an approach would fail to recognise any "step changes" in these markets. The CIA recognises that the current yields on Government bonds is very low compared to historical standards, however we would urge Ofgem to rely on the findings of their consultants to assess whether this is a short term anomaly or a near term step change.

Question 8.3: How should we reflect the risk profiles of licensees in estimating the cost of capital? Are risks below the market average?

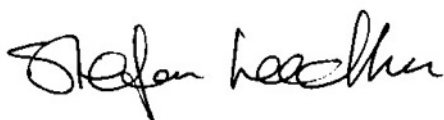
The CIA would note that the number of monopoly providers in the market earning guaranteed revenue is not significant. We would therefore suggest that the risks associated with this type of investment are less and so the cost of capital should be below the market average.

Question 8.5: Which option (or combination of options) should be used to address the loss of income from pre-vesting assets becoming fully depreciated?

The CIA would question why this situation was not addressed when a straight-line depreciation methodology was adopted. The CIA would further note that ultimately this is a cash flow issue, and how this shortfall would be funded. We would therefore suggest that this decision may best be left to the market, and so the do nothing option is desirable.

I hope you find these comments useful, and please contact me should you require further clarity on any of the points raised.

Regards



Stefan Leedham