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**Your Ref** 51/06 & 51/06b

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**SENT BY E-MAIL**

**Date** 28 April 2006

Dear Robert,

### **Transmission price control review – Third Consultation**

EDF Energy plc is a major UK registered company owning a number of companies active in the UK electricity and gas markets. Among these are subsidiaries responsible for the operation of power distribution networks, the operation of power stations and the sale to end users of electricity and gas. We are grateful for the opportunity to respond to this consultation and our comments on the issues raised in it are detailed below. We confirm that our response can be published on the Ofgem website.

#### **Form and structure of the price control**

We continue to support the use of RPI-X regulation and five year price controls. We also believe that the application of rolling mechanisms does provide a useful solution to the issue of periodicity. However, it should be noted that the DPCR4 capex mechanism was not a rolling mechanism per se but a defined incentive scheme. Under the scheme companies are allowed to keep a defined percentage of any efficiency or are required to bear the same percentage of any overspend, irrespective of when the under or overspend occurred in the period. If a mechanism is to be applied to operating expenditure it should also follow these principles.

We acknowledge that the use of an information quality incentive provides Ofgem with an approach to minimise the risk of “over-rewarding” companies. However, the use of such a mechanism does not obviate Ofgem from the responsibility of undertaking a robust assessment of a company’s capital expenditure requirements. In fact in order for the mechanism to work correctly a detailed assessment of the company’s capital expenditure requirements is vital. Only after such an assessment can Ofgem develop a credible menu of cost allowances and incentive rates. Without such analysis any mechanism developed will simply be a lottery. This is clearly inappropriate.

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We do not support the use of differential incentive rates for new and existing assets. This issue is also considered in detail in the Ofgem/OFWAT paper on financeability and we will be setting out our views on this issue in our response to that consultation.

We also believe that the Innovation Funding Incentive should apply to transmission licensees. The transmission companies also face the same issues as distribution companies in recruiting power engineers. It has been widely recognised that to address this issue, careers in the power industry must be made more appealing to young people. We believe that one aspect of achieving such a change in perception would be for Ofgem to establish an Innovation Funding Incentive for the transmission companies.

### **Electricity transmission revenue drivers**

We agree that locational revenue drivers based on power flows between zones or system boundaries would allow revenue flows to respond to changes in the demand for network capacity. The advantage of such an approach is that it is at a sufficiently high level that strategic and efficient network reinforcements can be taken forward in response to clear trends in generation new build.

The boundary between fixed baseline revenue allowances and variable revenue allowances also becomes less important where an effective set of revenue drivers are in place. Typically we would expect that strategic reinforcement of the network to accommodate general trends in the demand for transmission capacity should form part of the baseline revenue allowances. This should include some of the shared user reinforcement works in cases where multiple potential connections indicate a high likelihood of future capacity requirements.

Ideally, the combination of baseline revenue allowances and variable revenue drivers would be sufficiently flexible to handle the vast majority of network development and reinforcement requirements within a five year time horizon. However, where exceptional circumstances do arise then we consider that the proposed major investment should be referred to Ofgem for a decision on whether the investment and its associated price control impact is appropriate. Examples of such circumstances include a major extension of the transmission system to the Western Isles, Orkney or Shetland or if the additional investment is likely to jeopardise the maintenance of investment grade credit ratings. This should be a simple and focussed review process aimed at facilitating timely progression of appropriate major investment projects.

### **Electricity transmission access arrangements**

EDF Energy is open to consideration of alternative options for transmission access arrangements and have been participating in Ofgem's access reform options development group (ARODG) and we look forward to the opportunity to comment in detail on the ARODG final report.

In particular our views on User Commitment are as follows:

- Levels of commitment prior to connection in the form of Final Sums Liabilities are currently potentially high and volatile. We do consider however, that a financial commitment at this stage is important to reflect the risk associated with any user driven reinforcement works.

- Pre-connection arrangements should recognise the key decision points in the progression of new generation and network reinforcement projects and identify commitment points that minimise risk on both sides.
- Requirements on connected users to commit to longer term access products are unlikely to result in better information on future capacity requirements. Plant closure or life extension decisions will be driven by other market and regulatory factors which will typically outweigh the cost of transmission access.
- We consider that the current underlying access arrangements should continue i.e. where a generator is able to retain their right of access to the system for as long as they are willing to pay TNUoS charges for that level of access. However, we recognise that it may be possible to enhance these arrangements by offering alternative less firm or limited duration access products.

We support the process that Ofgem has put in place to consider options in an Ofgem led working group. However, we do have some concerns about the detailed development of options under the various governance arrangements given that any changes will likely have an impact on a range of licences, codes and charging statements. The main concern is that there will continue to be disparate views from different market participants on the best way forward and this could result in a large number of potential changes being progressed in parallel with the consequent complexity and uncertainty for the industry in the meantime.

### **Gas entry incentives**

We disagree with Ofgem’s proposals to change NGG’s licence obligations relating to the release of entry capacity. Whilst Ofgem is correct in observing that capacity does not always sell above reserve prices at certain terminals we believe that this merely shows that demand is not great enough at these terminals to warrant purchasing capacity in primary auctions. In practice it is difficult to see how physical gas can follow capacity as not all shippers flow gas at each and every terminal. Ofgem makes no reference to the capability of transferring capacity across the country, even with the use of “exchange rates” which makes it difficult for us to assess whether their proposed model will work and its relevant merits. We do not believe that the case has been made for such radical changes and we are not convinced Ofgem’s new proposal will be more efficient in practice.

In addition, the existing approach of using stable unit cost allowances (UCA) to set reserve auction prices works well. We believe there should be a single updating of UCA’s and these should then be used to set reserve prices for entry capacity auctions within the next transmission price control period. Ofgem’s current proposals look more complex and less transparent than the existing arrangements with no quantified benefit associated.

We agree that the costs associated with the late delivery of incremental capacity should not be passed through to the majority of shippers and therefore consumers but incurred by NGG (and to a lesser extent by the affected shipper).

Special buyback arrangements for new issue incremental capacity must have the following features. Firstly, NGG must remain incentivised to deliver the capacity in the shortest possible time. Secondly the arrangements must recognise that the administered price could substantially commercially penalise the unconnected gas source relative to the value it would have generated had it been connected. These two factors suggest that the optimal administered buyback price is likely to be high and that NGG must be exposed to the majority of its value.

## **Gas Offtake incentives**

We agree broadly with the proposals for the transitional period and the fact that there are no separate baselines and revenue drivers for the GDN flexibility product.

As outlined in our response to the second Transmission Price Control Review consultation EDF Energy continues to believe that the current gas exit arrangements, which are similar for DNs and DCs (Directly Connected sites), are not discriminatory, as we have seen no adverse effects or customer complaints as a result. Rather we believe that some of the more complicated models for bidding for exit capacity that Ofgem has presented would be unduly discriminatory because DNs have linepack and storage within their systems, flow management capabilities and many offtake points that are not available to DCs. If exit arrangements in gas are reformed in the manner suggested by Ofgem, different regimes should apply to DNs and DCs to reflect this fundamental difference in the nature of offtakes. Below we give our comments on the proposals put forward in the third consultation.

Of the long-term user commitment models presented by Ofgem in table 5.1 we agree broadly with Ofgem's proposals to support option 2 to have a nodal product and nodal level for setting baselines. However we do not believe that substitution between nodes is necessary given that capacity always stays with the meter point and not many NTS offtakes change their level of capacity requirements. We therefore do not believe there will be much capacity available for substituting at a Shipper level, perhaps only at a DN level. This supports our view that under Ofgem's proposals there should be separate products / regimes for DNs and Shippers as to do otherwise would be discriminatory.

## **Environmental considerations**

We welcome the focus that Ofgem is placing on its environmental duties. We believe that the work it has commissioned on understanding the possible impact of meeting environmental expectations on price control allowances will be valuable and it would be useful if Ofgem could publish this report when it has been completed. We would continue to encourage Ofgem to undertake a willingness to pay survey which covered both environmental and quality of supply issues.

## **System Reliability Incentives**

We believe that the transmission companies should be incentivised to deliver the outputs that customers' value. We would expect that the base allowances will be sufficient to allow companies to maintain their current levels of reliability. If customers indicate that they want improved levels of reliability then the companies should be funded to deliver that improved reliability. If the companies exceed their reliability targets they should be rewarded and if they fail to achieve the targets they should be penalised.

## **Approaches adopted for capital assessment**

We believe that Ofgem's proposed approach to assessing forecast capex requirements appears appropriate. However, it is unclear as to how the proposed detailed assessment of asset management policies interacts with Ofgem's work on Asset Risk Management. It would seem sensible to ensure that work is not duplicated between these two projects.

The alignment of capitalisation policies needs to be considered with care. The future capitalisation policy of an individual company will be dependent on its level of capital expenditure and particularly if it is ramping this up relative to historic levels. It would, however, seem sensible for Ofgem to ensure that any decision it makes on capitalisation policy, with respect to the Scottish companies, does not provide a perverse incentive for those companies to allocate more shared overheads to the transmission company.

### **Treatment of capex to support operational efficiency**

We recognise that in principle there would be benefits in the GBSO co-ordinating the trade off between SO costs and capex for improving the efficiency of system operation across the whole GB system. However, the actual operation of such a scheme needs careful consideration, particularly with the allocation of risk e.g. delivery risk between the SO and the TO.

### **Overall approach to assessing opex**

We support Ofgem's proposal to utilise both top down and bottom up benchmarking to obtain a balanced view of opex requirements. We also support the continuing treatment of network rates as non-controllable opex. With respect to the treatment of non-operational capex we believe that such expenditure should be capitalised over the true lifetime of the assets. The assets tend to deliver longer term benefits and hence are more akin to capex than opex and this should be recognised in their treatment.

We have a significant concern with respect to Ofgem's Real Unit Operating Expenditure (RUOE) analysis. Ofgem implies that the impact of business separation had a limited impact on the RUOE of the distribution companies. We do not believe that this is the case. At DPCR3 the allocation of customer service activities such as meter reading moved approximately £220m (1997/98 prices) from distribution companies to supply companies. This figure represented approximately 15% of the total distribution controllable operating costs.

### **Cost of Capital**

The setting of an appropriate cost of capital will be vital in ensuring that the transmission companies can attract the necessary investment to support their investment programmes. Ofgem has highlighted that the recent historically low government bond yields may have implications for the risk free rate. There are however a number of structural reasons why the yield on government bonds is at historically low levels. These include the increased requirement by pension funds for long term index linked gilts and a shortage of such instruments.

In constructing its view on the cost of capital we would encourage Ofgem to utilise long term averages to estimate the components. The use of short term estimates for certain elements and long term averages for other elements will produce inconsistent and unsustainable estimates of the cost of capital. This is in neither Ofgem's nor the companies' interests.

From its terms of reference, for the cost of capital study, Ofgem would appear to be looking at the Fama French model as alternative methodology for calculating the cost of capital. We would also encourage Ofgem to utilise other methods such as DGM or

Tobin's Q ratio. It is vital that whatever method Ofgem uses to calculate the cost of capital that it meets certain key criteria. They are that:

- it has a sound theoretical underpinning,
- it can be explained clearly; and
- the component elements can be assessed objectively preferably via publicly available data

### **Financial stability**

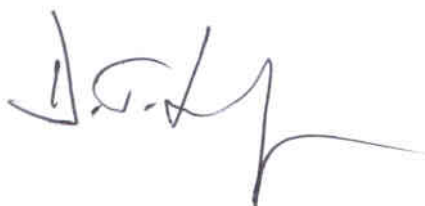
We believe that financial stability will become an increasing issue as the UK seeks to renew large proportions of its network infrastructure. We note that Ofgem have commented on the growth of thin equity models in the US. It is unclear whether the prevalence of such models is driven by differences in the regulatory regime. However, if Ofgem wish to assume that companies will move to higher levels of gearing then it must also calculate what effect this will have on the respective betas. It is important that any calculation of the cost of capital is internally consistent and it would be inappropriate for Ofgem to make assumptions with respect to one element without understanding if this impacts on another element.

We support the retention of a policy to assume a target credit rating 'comfortably within' investment grade when assessing a licensee's financial stability. We believe that Ofgem's proposal to redefine what is meant by 'comfortably within' investment grade credit rating in practice means a lowering of the threshold to meet that requirement. In our view this is inappropriate.

It must be remembered that the lower the level of a company's current credit rating the higher the probability that it could be downgraded to below investment grade, at some future date. If the majority of company ratings were say BBB there would be a significant risk that several companies would fall below investment grade, in the event of future downgrades. Furthermore, in view of the higher yields which are required by investors on the debt of companies with lower ratings, it is unclear that reducing ratings would reduce the weighted average cost of capital (WACC).

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

Yours sincerely,

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

**Denis Linford**  
**Director of Regulation**