

Robert Hull  
Director – Transmission  
Ofgem  
9 Millbank  
London  
SW1P 3GE

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Dear Mr Hull

### **Transmission Price Control Review (TPCR) 2007 - 2012: Third Consultation**

energywatch welcomes the opportunity to consider the issues raised by this consultation. We comment on the questions raised in the document as appropriate.

#### **General comments**

We are disappointed that Ofgem provided only four weeks to respond to this consultation given the importance and detail of the subject matter. The consultation period included the Easter break, limiting further the time to respond. Ofgem must be aware that, for most interested parties, the consultation process is the only opportunity to make representations on these issues. For energywatch to provide a meaningful contribution on behalf of consumers, we consider that a minimum of six weeks would have provided a preferable consultation period, particularly as the next price controls potentially impose significant costs on consumers if transmission owners (TOs)' proposed estimates of investment are approved. We hope Ofgem will allocate adequate time to respond to the initial proposals to be issued in June 2006, particularly as that consultation will coincide with the start of the summer holiday period.

It is essential that the process allows for the development of a coherent, harmonised and effective set of electricity and gas price controls but it is equally important that the review should have specific aims to achieve in the interests of consumers particularly the most vulnerable. energywatch believes these to be:

- the delivery of secure and reliable supplies of energy to all consumers (the achievement of 'security of supply');
- the delivery of energy supplies to all consumers in a cost effective, efficient and economic manner (the achievement of 'investment at optimal cost');
- the delivery of safe supplies of energy which do not put any consumer in danger (the achievement of 'safety of supply').

These objectives are not prioritised in any way – each is equally important, and an effective set of price controls will recognise the importance of achieving a suitable balance between them as part of the overall framework.

Although we welcome Ofgem's intention to provide a draft assessment in time for the initial proposals document, it would have been helpful if Ofgem had provided a preliminary impact assessment at this stage of the TPCR. A cost-benefit analysis of the proposals against Ofgem's wider statutory objectives may help crystallise the arguments for pursuing particular options for access and incentives, so as to identify ways in which to efficiently invest in the networks.

We are also mindful that the outcomes of the Government's Energy Review could impact significantly on the TPCR and that the process itself should be flexible and robust enough to address any potential transmission network related issues arising from the Review. There is a pressing need to address strategic supply issues for both electricity and gas given recent pricing events in wholesale energy markets which have adversely impacted on consumers in general, but the most vulnerable consumers in particular. We would be keen to see incentives and network arrangements which enhance both investment in and the supply of gas to Great Britain, with the resulting impact this has on the security of electricity supply, as this is the best way to improve reliability of energy supplies at optimal cost to the consumer.

### **Form of the price control**

A RPI-X form of price control over a five-year period remains our preference for the provision of appropriate base price control revenue allowances to the TOs to develop and operate cost efficient transmission networks. The form of control is both familiar to the TOs to whom it applies and provides a means for them to realise cost efficiencies which can then be reflected in future savings to be shared with consumers. However, the base price control should be capable of being flexed to provide more focused incentives on the network owners to improve security, reliability, safety and cost efficient operation of networks. Appropriate mechanisms should be built into the price control to give effect to this.

We note that, with the extension of current electricity and gas price controls to facilitate a harmonised approach from 1 April 2007, the regulatory asset value (RAV) will have changed for the various TOs because of capital expenditure incurred in the interim. Consumers should expect that only expenditure justifiably incurred on an efficient basis will be included in the starting RAV for the next price controls. TOs should not be permitted to earn a return on investment which has been made on an uneconomic basis and we request Ofgem to adopt this approach when setting initial RAV values for the new price controls.

We note that System Operator (SO) incentives schemes also need to be renewed from 1 April 2007. In the past, these schemes have used target values with appropriate caps, collars and sharing factors, and we agree that there is value in extending these schemes. We note Ofgem's view that aligning SO incentives schemes and the TO price controls may provide some benefit in terms of cost savings. However, these benefits are not quantified as yet. Also, a balance is required

between aligning the length of schemes, given recent uncertainties in the wholesale energy markets which may make it difficult to value the benefit of providing long-term SO incentives. We also need to see real benefits, in the shape of lower costs to consumers, if there is to be unbundling of elements of the SO costs and incorporation of these in TO price controls. We note that having sufficiently robust targets on National Grid has been an ongoing issue in the electricity SO incentives schemes. Incorporating some elements of the SO incentives in TO price controls must only occur on the basis that challenging targets are set which are justified in terms of improved efficiency.

### **Other forms of incentive and investment revenue drivers**

In general, we agree that TOs must be incentivised throughout the price control period to realise savings, to ensure that benefits to be shared with consumers can be spread and networks operated efficiently as a result. Ofgem's proposal to use rolling incentives does appear to allow for better management of cost recovery over time. However, we are unclear about how effectively the mechanism will operate in practice and there seems to be uncertainty about the interface with efficient investment on the networks. There must be a clearly established package of incentives to allow TOs to maintain sufficient levels of investment which are appropriate to the demand connecting to, and providing security of supply on, networks. Any incentives schemes need to have the characteristics of simplicity, transparency, consistency and coherence to ensure that the TOs fully understand how consumers expect them to deliver safe and secure supply at optimal cost on a timely basis.

We are also unclear as to the purpose of information quality incentives. In all cases, the TOs should not be expected to exercise a choice about the level of revenue allowance which they secure depending on the adequacy of their cost estimates. The TOs should be focused on delivering a safe, secure, reliable and cost efficient network to consumers and need to plan investment accordingly. Why separate incentives are required needs proper justification. The quality of TOs' estimates to Ofgem should reflect the objectives we outlined previously, and not hinge on the level of financial benefit to be attained by delivering a particular set of estimates. Ofgem should clarify how this incentive would operate in practice.

We note the reference to innovation incentives which have recently been developed under the distribution price controls. We would require more information about how these may operate before we feel able to comment in detail on their possible inclusion in the TO price controls. Innovation which is directed at surpassing best practice to improve reliability and safety of networks may be justifiably incentivised. However, we note that system reliability is already the subject of incentive schemes. These are also to be renewed on 1 April 2007. Consumers expect minimal interruptions, if any, to supply. The TOs must prove that they have planned their investment in such a way as to achieve an agreed minimum standard of performance for consumers. We agree that penalties may form part of such an incentive regime.

While we agree that specific revenue drivers may provide the flexibility which we believe is needed to assess the efficiency of additional investment on the electricity networks, and thereby keep costs low for consumers, the type of revenue drivers

used need to be carefully considered. Use of locational revenue drivers would certainly focus on additional capacity which is geographically specific. In view of the geographic disparity in projections of future additions to capacity highlighted in the estimates provided by the TOs, it is arguable that locational drivers better recognise that consumers are best served by ensuring that incentives are applied more effectively where actual network costs are to be incurred. However, given that Ofgem is not comfortable with pure locational revenue drivers, we would request Ofgem to explore whether there is a happy medium between increasingly regional revenue drivers and the global approach of the status quo. We agree that revenue drivers need to be effective so that incentives on cost efficient investment are not diluted.

### **Transmission access arrangements**

We note the ongoing work to develop transmission access arrangements and that possible reform of current arrangements will require modifications to various industry codes. We will play our part to ensure that consumers' interests are represented when firm proposals are forthcoming. If there are doubts about delivering access reform in the same timescales as the next price control, further consideration should be given to managing reform to optimise its timing so that incentives are not dampened.

We are particularly concerned that the 'first come first served' process used by the TOs for assessing applications to connect to the transmission networks may be stifling access to potential connectees with fully developed plans for using capacity, which in turn could improve system security for consumers.

We agree that more user commitment should be sought (although the details of how to deliver effective financial incentives on potential users need further development) to ensure that barriers to entry and access are reduced. Ofgem should give further thought to any regulatory changes which could assist generators who are able to enhance system security for the benefit of consumers to gain earlier access on a cost efficient and non-discriminatory basis. An economic argument must also be put forward for further network reinforcement which provides adequate system security and this should be accompanied by a cost-benefit analysis. These changes may also ensure that generation which cannot enhance system security, is uneconomic to connect to the grid or merely speculative is placed lower down the queue. Failure to address these queuing issues could create consumer detriment in the form of payment for stranded assets. It is possible that some generation may not be cost efficient to connect at any cost. The safety and reliability of supply then becomes a counter-balance to the cost of connection.

While we recognise the arguments for rationing capacity when this is scarce, there is also a strong argument for freeing up any unused existing capacity to ensure that reinforcement costs are not unnecessarily incurred. An effective 'use it or lose it' regime, which allows firm access to third parties on an economic basis should be encouraged where possible. TOs have a role to play in providing an appropriate regime and incentivisation may improve the granting of access.

We are keen that any access reform considers how to enhance firm access for users once connected, that there are appropriate economic and incentivised solutions to the release of capacity (in the long and short term) when there is under-utilisation, and the possibility, in the longer term, of some form of trading of access for existing and incremental capacity. The next TOs' price control may need to reflect some of these issues.

We are committed to ensuring that every consumer should have access to safe, secure and reliable energy supplies where these can be delivered on an economic basis. We will look to the development of TO price controls to provide sufficient incentives for network reinforcement which allows more consumers who currently have no access at all to gas or electricity to be provided with these services.

### **Gas entry and offtake issues**

We agree that there needs to be reform of the approach to release of gas entry capacity at relevant entry points on the National Transmission System (NTS) by National Grid Gas (NGG). While it may be appropriate to continue the auctioning of capacity to ensure that capacity is available on a cost effective basis, the key problems appear to be lack of proper information about the availability of capacity, and effective mechanisms for NGG to buy back capacity and re-release it to ensure that safe and reliable supplies are provided to consumers.

We agree that NGG should be obliged by licence to develop a transparent methodology which outlines how it intends to conduct the release of capacity in an efficient manner which enhances safety and security of supply. Improvements to information will allow greater competition to develop amongst shippers for capacity and improve the prospects for delivery of capacity at reduced cost in the long run.

We agree that appropriate revenue drivers should be applied to NGG to ensure that existing and incremental entry capacity is made available in a cost effective manner and in a way that enhances system security and reliability. Greater emphasis on gaining user commitment may be one way in which to ensure that capacity, once made available, is firm and used. Where capacity is unused, incentives should be in place to maximise use by third parties through 'use it or lose it' mechanisms, which keeps costs low and minimise consumer detriment. Ofgem has indicated that locational revenue drivers at specific entry points may be suitable to incentivise efficient investment in connecting to, and using, the grid. Any such revenue drivers would need to be simple to understand and implement. We await Ofgem's detailed proposals on the scope and operation of these drivers.

We also agree that capacity buy-back arrangements, particularly where incremental capacity may be delivered late to the network, should involve capping of the liability and should impose a greater risk on NGG and the shippers who have agreed, but failed, to deliver that capacity. Consumers should not be expected to bear the risk of late delivery of capacity when they have no ability to manage that risk, and additional costs are created on the existing network without enhancing system security or reliability. A fairer spread of risk, limiting consumer detriment, should be reflected in the capacity buy-back mechanisms, which should be both simple to understand and transparent to all parties.

We note that gas offtake arrangements remain under development for the transitional period and on an enduring basis. We would support arrangements which provide a consistent and coherent framework with the proposed gas entry regime, taking into account any specific areas where differentiation may be required. However, the incentives on NGG for offtake of existing and incremental capacity should be framed in a way that reflects the provision of capacity on a cost effective basis and which preserves reliability on the NTS. Again, the development of 'use it or lose it' mechanisms and firm user commitment to offtake from the grid may help to lower the ultimate costs for consumers.

### **Other comments**

We have highlighted that consumers are best served by the delivery of reliable, secure and safe networks at optimal cost. There are interfaces between transmission and distribution networks which also need to be managed in a coherent and cost effective manner. We would encourage Ofgem to consider, as part of the price controls, means by which to ensure appropriate information exchanges between distributors and transmission/system operators, facilitated by governance structures where necessary, to ensure that efficient investment takes place on networks which provide costs savings and flexibility of operation between the networks.

We noted in our previous response that a key deliverable from this price control should be cost savings resulting from the harmonisation of investment on gas and electricity networks, which also maximises safety and security of supply. National Grid's role across the energy markets as a transmission/system operator should allow for the realisation of these cost savings through integrated management of the networks. We still await details on how cost savings have been realised from the merger of National Grid's electricity and gas operations and how these have been passed through to the benefit of consumers. We note that reference has been made to these savings in terms of the historic capex and opex which has been incurred by National Grid compared to its revenue allowance under the current price control. However, there is a lack of transparency about the savings which National Grid should clarify.

We will continue to keep all the issues raised in the TPCR under review and respond through the consultation process, and in other ways, always considering the possible impact on consumers.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley  
Head of Regulatory Affairs