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Dear Robert

Transmission Price Control Review (TPCR): Initial Proposals

energywatch welcomes the opportunity to respond to the issues raised in the document setting out the TPCR initial proposals. This response is non-confidential and we are happy for it to be published on the Ofgem website.

General comments

We are disappointed to note that, despite our previous comments about the tightness of timescales, this consultation still only allowed four weeks for a response. Whilst we appreciate that some respondents may become familiar with the material over time through some repetition, we believe that a six-week consultation period should be the **absolute minimum** in which to fully understand the implications of the proposals as they develop. This was particularly the case for this consultation as it coincided with the summer holiday period. The consultation process is the main method of contributing to the process for many, particularly those who seek to represent the views of consumers – the ultimate payers of the costs associated with the review – so Ofgem must ensure that it allows adequate time for its consultations if it is to ensure considered responses from everyone.

We reiterate the view that consumers expect the development of a coherent, harmonised and effective set of electricity and gas price controls during this TPCR, given that there are interactions between the two energy markets. Likewise, we restate the key objectives that consumers, particularly the most vulnerable, expect to be achieved as a result of the TPCR, namely:

- the delivery of secure and reliable supplies of energy to all consumers ('security of supply');

- the delivery of energy supplies to all consumers in a cost effective, efficient and economic manner ('investment at optimal cost');

- access to, and the delivery of, safe supplies of energy which do not place any consumer at risk ('safety of supply').

These objectives are all of equal importance. An effective set of price controls should, in a balanced way, ensure the delivery of them all for the benefit of consumers.

We recognise that there needs to be significant investment in the transmission infrastructure and proposals to date from the transmission companies have highlighted that both reinforcement and replacement is necessary. However, we agree with Ofgem that investment needs to be based on firm projects and not on speculative requirements. We will discuss this further below.

We have previously expressed concern about the connections queue in electricity and how the 'first come first served' approach may be allowing speculative projects to 'queue jump' ahead of projects which have a firmer basis both on a financial and physical level to improve security of supply. Consumers clearly benefit from the increased security of supply which firm projects should provide, as well as certainty about the appropriate allocation of risks. Consumers cannot manage the risks of investment on the grid and rely on National Grid (NG) and others to do so. We consider that NG and the other transmission companies should 'weed out' speculative applications for connection to the grid and set appropriate financial incentives to encourage the provision of firm rights to connect. We note that NG has already begun to implement an interim solution to adjust the Final Sums Liability approach to obtain firmer commitments from potential users who in turn would receive firmer physical rights to access on the grid. This would in due course give way to an enduring solution implemented through the Connection and Use of System Code (CUSC). We also note that there have been discussions on initial options for reforming access arrangements to which we have contributed and we intend to continue to provide input to this debate on behalf of consumers as proposals are developed further.

We are concerned that the TPCR process should establish adequate parameters for investment in the gas network which allows those consumers who are currently 'off gas' to have access to the National Transmission System (NTS). The enduring regimes for gas offtake, capacity buyback and capacity release must be reflective of efficient means to connect 'off gas' communities. While we appreciate that there may be increased risks associated with relaxing the planning rules to allow more connections, auctioning of capacity and the possibility of significant costs to NG and cost pass throughs to consumers of unused capacity buy back, there should be a balanced approach which also seeks to create a greater degree of financial commitment on possible users to provide upfront the costs of connection. Stranded asset risk can be mitigated if firm financial commitments for access to capacity are given.

We note that the impact of the initial proposals is generally slight in respect of domestic and small business consumers as the transmission element of these consumers' bills tends to be relatively small at around 2-3% of the total. However, we are concerned that large energy intensive users are likely to be impacted more significantly and that there is a real risk of tariff disturbance if the process of implementing the price control is not managed appropriately – step changes in TNUoS charges, through which the price control allowances are recovered, need to recognise the longer contract periods over which large users tend to purchase their energy and adequatte notice of changes to charges should be provided as a matter of course.

We note that Ofgem has not yet provided a full regulatory impact assessment of the initial proposals but instead its assessment of different elements of the proposals which helps to give a fuller explanation of the proposals at this stage. We trust that this practice will continue as the TPCR process develops further.

We noted in our previous response that the outcomes of the Energy Review may have a significant impact on investment requirements for reinforced and replacement infrastructure. Now that the conclusions of the Review have been published, we expect the September 2006 updated proposals to include further information on the effect of the impact and whether there is a resultant change to the baseline allowance. Consumers require that long-term security and safety of supply is reflected appropriately in the firm projects upon which the underlying baseline allowance is set. The Energy Review outcomes may be more adequately reflected through the adjustable revenue drivers.

Structure of revenue allowances

We agree with the structure of the price controls as set out in the initial proposals. We regard the use of a fixed 'baseline' revenue allowance based on the firm requirements identified for network investment for replacement and reinforcement to be appropriate and the most cost effective approach for consumers. We note that separate revenue allowance arrangements have already been made for transmission investment in renewable generation (the TIRG settlement). We agree that, only if necessary, and where uncertainties around efficient investment are resolved fully and satisfactorily, it may be appropriate to supplement the allowance with additional revenue streams. Ofgem has identified that this may yield a further £750 million in capex revenue to the transmission companies above the fixed allowance of £4.25 billion, but should be considerably lower than the original bids of £6.7 billion.

The use of revenue drivers provides a degree of flexibility which we consider is required to determine whether supplementary revenue ought to be made available. However, consumers demand that Ofgem should rigorously scrutinise any new projects presented by the transmission companies, which may lead to additional revenue streams for them, in line with the objectives we set out above. In other words, efficient and economic investment based on a clear and justified need for replacement or reinforced infrastructure must be presented. This would minimise the risk of creating stranded assets and allow the optimal use of the existing grid.

We agree that the flexible approach adopted through the use of revenue drivers should include the ability to **reduce** the amount of revenue made available to transmission companies as well as to increase it where this is absolutely necessary and unavoidable, as there may be certain projects which are no longer viable and which can be curtailed without further investment in stranded assets. We also believe that consumers require comfort that significant projects should be subject to an extensive efficiency assessment by Ofgem after the event which should reveal whether the projects have been cost effective, and which allow the adjustment of future price control allowances to reflect the outcome of the assessment. We note that there are various options under discussion on the type of revenue drivers which are most appropriate and we will consider these options through the consultation process as necessary in the lead up to updated TPCR proposals in September 2006.

We agree with Ofgem that re-openers are not a suitable basis for developing the price control for two reasons. Firstly, there is a real risk of initially allocating excessive revenue allowance to the transmission companies and the potential for disputes over projects which are not viable and merely speculative. This would be inefficent. The price control re-opener may retrieve some monies but consumers will have been immediately disadvantaged through the original price control settlement. Secondly, the re-opener process itself involves further expense and time on the part of the industry which needs to be reimbursed in some way.

Cost assessment and related issues

We note that Ofgem has undertaken an efficiency analysis to derive the initial baseline revenue allowances for the three electricity transmission companies and NGG NTS. We note on the electricity side that replacement of assets is given significant priority in the capex plans of all the companies which may imply that there has been a relative underspend in this area through the existing price controls. However, we do not believe that that there has been any obvious implications for reliability of the network in the current price control period. We note that Ofgem, as part of the TPCR process, is seeking to improve its knowledge about the current state of existing network assets, their lifespan and whether the failure to replace assets previously is due to increased 'sweating' of assets which could have implications for their efficient use. Consumers support the need for improved and effective monitoring and regulatory reporting to help determine efficient asset usage.

We support the view that transmission companies need to provide increased transparency about how they use assets so that adequate estimates can be made of asset life and whether replacement expenditure is altogether necessary. Consumers require assurance that companies' estimates of asset replacement leads to the most efficient and optimal outcomes for operation and expenditure. Increased monitoring of costs by Ofgem and increased openness from the companies about their assets and proposed expenditure should be requisite in this respect.

We are led to believe that the opex costs reflected in the initial proposals for NG include the efficiency savings derived from the merger of Lattice and NG towards the beginning of the current price control period, specifically savings relating to use of IT and other areas where harmonisation was possible. It would have been helpful to have seen these figures on the face of the proposals document. Consumers demand that Ofgem should be clear about the efficiency savings which have been achieved, preferably by transparent and published means in the proposals for the next price controls, and can therefore be easily identified in the next price control allowances going forward.

Following on from this point, we note that one of the reasons for the harmonised consideration of the various transmission price controls from 1 April 2007 is that it allows efficiency savings to be identified across operators and across gas and electricity. Ofgem does not intend currently to align capitalisation and is happy to continue with the individual approach for each of the companies. We believe that Ofgem should keep an open mind and seek to apply the principle of harmonisation where there are identifiable efficiency savings to be gained. A more transparent and consistent approach to identification of costs under various headings may help to determine whether savings are feasible.

We have no specific comments to make on the financeability issues raised in the proposals document. We note that all electricity transmission operators are to be subject to the same cost of capital given that they are all operating in the same market and the costs of assets should be the same for all and not geographically delineated. We agree that this approach is a sensible one as there is an element of certainty for the operator about the basis upon which returns on investment will be based.

We note that there may be unforeseeable events in future which may affect the revenue allowances but, as with revenue drivers, we believe that Ofgem should be rigorous in scrutinising the circumstances and should determine whether allowances ought to be adjusted only after full consultation. Ofgem must be absolutely satisfied that such additional costs were completely unavoidable. Consumers should not expect ‘surprise’ costs to be passed through to them without clear and full justification.

Other comments

We note that ‘rolling incentives’ may be one way to improve efficient spending by the transmission operators while providing a degree of leeway around baseline expenditure. We need to know more details about how this would operate as consumers would be fully opposed to such a mechanism being used in a way which allows increased but inefficient expenditure. We look to Ofgem to provide information which will help us and others decide the appropriateness of the use of ‘rolling incentives’ and reaffirm our view that transparency and justification for expenditure under any rolling incentives is important..

We agree with Ofgem that transmission companies should be subject to the same cash ‘lock-up’ arrangements as distribution operators. This should ensure that, in the unlikely event of a transmission company going into ‘energy administration’, assets and cash would be prevented from being transferred outside the company. However, we would not expect consumers to pay for the mismanagement of these companies which may have led to the administration event in the first place. Consumers have no control over the circumstances which may have given rise to administration.

We note that Ofgem is continuing to monitor NG's electricity system operator (SO) activities closely to ensure that there is efficient expenditure in the absence of a SO incentive scheme. We expect Ofgem to undertake effective monitoring action, reporting back on the outcomes, and support the holding of NG to account. Any additional expenditure for SO activities must be appropriate, justified, and not as a result of expected and avoidable activity. We already note that NG has raised income adjusting event claims in connection with last year's SO incentive scheme.

We note the introduction of reliability incentives on the electricity transmission companies in 2004 after a number of high-profile incidents on the grid in 2003. We agree with Ofgem that performance of the transmission companies needs to be benchmarked appropriately to ensure that suitable incentives can be applied to enhance reliability on the network. While a 'penalties only' regime may seem a good starting point, the benchmark for reliability, whether determined from historic data or in some other objective way, should be sufficiently rigorous and challenge the companies to limit poor performance which causes consumers to go off supply. As noted above, we believe that expenditure on replacement assets should be driven solely by a need to remove assets at the end of their lifespan but that existing assets are used efficiently and on an optimal basis.

We note that Ofgem proposes the use of innovation incentives, similar to those now being operated under the distribution price controls, for the transmission networks. While we see the use of innovation in distribution as a way for the DNOs to reach out to their consumers in a more effective way as well as improving their service to them, the use of innovation on the grid would, we envisage, be more appropriate as a means to increase technological prowess and improved performance of the grid. Consumers tend to be removed from direct contact with grid operators. Therefore, the emphasis of innovation must be on ensuring that consumers would benefit from a more efficiently-operated grid. The innovative process ought to establish a common benchmark for increased reliability on all parts of the grid without necessarily dampening the transmission companies' ability to obtain a commercial advantage over each other in how their respective grids are operated.

Going forward, we will continue to keep these issues under review as the TPCR progresses, 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