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Our Reference NG/LAD

Dear Andrew,

Ofgem's Five Year Strategy 2007-2012

Further to Sir John Mogg's letter of 1 August 2006, we are pleased to have this opportunity to contribute to the development of Ofgem's next five year strategy. The consistency with which the key themes have featured in Ofgem's corporate strategy documents is reassuring and commendable. As with previous years, our suggestions concern facets of these themes where, it appears to us, there may be merit in recognising developments or emerging priorities.

Regulating Networks Effectively

Ofgem's work to review the main transmission price controls is now well advanced and the period 2007-2012 will coincide with operation of these controls as well as completion and operation of the gas distribution price controls. In this post main review environment we think some important areas are:

1) The specificity of the regulatory contract

Price controls, in so far as they provide a package of allowances to fund the efficient cost of various activities that may be needed to discharge high level licence obligations, tend not to identify the specific activities and costs that are or are not funded. This means that, once a control starts, any requirements to increase the volume of certain activities, incur higher unit costs, or even undertake completely new activities could well reduce returns below that rate which was deemed efficient when setting the control.

The enhancement of the mechanisms which automatically adjust revenues in response to market requirements will provide a tighter definition of the outputs required by the transmission business in respect of the volume of load related activities. We also expect that the extent to which we are exposed to the difference between actual load-related unit costs and unit cost allowances will also be defined (both through the updating process for UCAs and the agreed treatment of actual investment

costs). However, this leaves other areas where the regulatory contract would benefit from being more specific.

With respect to asset renewal, it is important to clarify whether the licensee's obligation is to:

- a) Incur asset renewal costs matching the price control allowance (potentially requiring the volume of renewal to adjust if unit costs depart from price review expectations).
- b) Out-perform the funding allowance by seeking both volume and price efficiencies subject only to meeting wider reliability targets.
- c) Undertake an agreed volume of renewal – with a mechanism to maintain rates of return if higher than expected unit costs are efficiently incurred (e.g. by back-dating financing allowances).

As well as clarifying the basis of the forthcoming transmission and distribution price controls, there may be new work areas over the next 5 years associated with monitoring actual investment and operating any associated true-up mechanisms.

Over the next 5 years, licensees are also likely to be required to undertake a number of new obligations. For example:

- Agreements for access and the co-ordination of flows over offshore transmission networks
- Gas blending and quality management duties
- Implementation and accommodation of further market developments, perhaps including those resulting from EU legislation and harmonisation

We understand concerns that any open ended commitment to fund incremental costs could provide poor incentives. However, where developments are driven by a regulatory agenda and so the scope is beyond our direct control, we are unable to provide firm commitments on all our development costs in advance. For this reason it cannot be assumed that such costs can be absorbed by licensees as part of normal transmission business and funded by the main price control. We support Ofgem's practice of formalising such industry tasks into new projects, with the Ofgem project managing industry work groups. We think the efficient and timely working of such projects can be enhanced by more formalised consideration of how specific work items should be resourced and remunerated.

2) Operation of risk mitigation measures

As well as revenue drivers, which provide adjustments for volume uncertainties at ex ante prices, it is likely that the new price controls will contain opportunities for adjustments to be made ex post. Such facilities may also be important in addressing certain costs that may be incurred as part of new projects mentioned above. They will continue to be needed in any future SO incentive scheme because, even with revenue drivers and market price indices, the effects of significant market rule changes may need to be addressed.

In operating any ex post adjustments it is important that ground rules are known in advance and we believe there is merit in developing these ground rules in the light of recent experience. In particular, consideration of the need and extent of an adjustment should focus on whether and to what extent the external factor took place rather than whether, given hindsight, the company could have taken a different strategic approach. A perception that ex post mechanisms will tend to use a full "benefit of

hindsight" stance will mean these measures will not be accepted as a useful risk mitigation tool and larger risk margins will be required in ex ante allowances as an alternative.

3) System operator incentives

National Grid is keen to have incentives on managing external balancing costs. As well as providing an opportunity to earn enhanced returns for superior performance, we think SO incentives, by internalising the external impacts of wider transmission investment and operating decisions, offers best practice in terms of aligning network company interests with those of the end consumer. Moreover, such incentives reduce the administrative burdens on Ofgem and ourselves that could arise if more extensive supervision of real-time operational decision making was otherwise required. An incentive-based regulatory approach also avoids establishing a regime which risks increasingly drawing Ofgem in to micro-managing operational decision making.

Following recent experience when, for various reasons, acceptable electricity SO incentives could not be agreed, we support the current updating of stakeholder views on such arrangements and eagerly anticipate renewed focus and engagement on identifying scheme mechanisms that address the impacts of external market factors.

4) SO to TO interface

The first full year of experience under BETTA has confirmed the nature of the challenges associated with accepting strong SO incentives (i.e. incentives which internalise the impacts of transmission decisions) when the responsibilities for delivering transmission services are split between separate SO and TO companies. We welcome Ofgem's proposals for developments in the regulatory regime concerning this interface currently being considered in the price review process (specifically, the introduction of facilities for initiating and funding Transmission Service Schemes in Scotland). In the next price control period we suggest there would be considerable benefit in Ofgem maintaining focus on this area so that experience with working these arrangements can be gained and the risks perceived by both SO and TOs mitigated.

Creating and Sustaining Competition

EU directives assume interconnector and LNG importation facilities will be promoted by TSOs or vertically integrated utilities and funded as part of the regulated charges of those businesses. UK legislation and licensing arrangements, however, means that funding through regulated charges is not available by default and, instead, the presumption in the UK is that these projects should be developed on a merchant basis with agreed income from their specific users. To safeguard returns on these merchant projects, developers will require Ofgem to approve and support an exemption from the RTPA obligations in the directives. This disjoint between European and UK defaults can be sustained while Ofgem facilitates the approval of appropriate exemptions but it could result in crucial infrastructure investments failing to progress if the process to obtain necessary exemptions becomes unviable. This will require on-going activity and focus from Ofgem over the next 5 year plan period.

In respect of Metering, we welcome Ofgem's intention to provide transparency and predictability of approach to the price control reviews. This is best delivered by keeping relevant price controls in both electricity and gas markets consistent, including their timing and the lifting of obligations to be a 'last

resort' provider. Within the review we hope that Ofgem will specifically deal with the low level of tariff cap on charges for gas prepayment meters and allow more cost-reflective charges to be set. We look forward to the final proposals scheduled for Q3 of 2006.

We welcome and support Ofgem's initiatives on metering innovation and efforts through the Supplier Licence Review to remove barriers to a market-led deployment of 'smarter' meters which could play an important part in delivering the UK's energy efficiency objectives. We suggest that it would be appropriate for Ofgem to recognise this benefit through the EEC scheme.

Delivering security of supply

Addressing the challenges arising from the increased reliance on gas imports and intermittent renewable generation will be key areas of activity in the next 5 years. Delivering this objective in accordance with Ofgem's aims of creating and sustaining competitive markets will require engagement with industry members (e.g. concerning exemptions) and European regulators and legislators,

Engagement with Europe

We support Ofgem's strong engagement in European energy market and policy issues, as identified in the previous strategy. Proposals for regional markets, market harmonisation, frameworks for developing and using interstate transportation are all central to future UK security of supply and health of our domestic energy markets. We are sure Ofgem are well placed to provide leadership in European regulatory forums towards workable solutions given the extensive real market experience from the UK gas and electricity markets.

I hope these comments are helpful and look forward to seeing the next stage in the strategy development.

Yours sincerely,

Lewis Dale

Cc: Paul Whittaker