

## Appendix 3 - Adjustment mechanisms & incentives

### General comments

- 1 This section covers our response to the adjustment mechanisms and incentives relating to gas (entry and exit) and electricity. It responds to the information contained in Sections 7, 9 & 10 and Appendices 7, 8 & 9 of Ofgem's September Update document.
- 2 In our response to the Initial Proposals document we made it clear that we would not find acceptable the current proposals contained in the Initial Proposals document if they were put to us as a final set of proposals. Whilst some progress has been made within the September update document, we remain of the view that the latest proposals would be unacceptable if they were put to us as a final set of proposals. It should be recognised that the proposals relating to adjustment mechanisms and incentives are sufficiently material to impact on the overall expected rate of return and are therefore material in the overall acceptability of the price control.
- 3 We remain of the view that it should be possible to amend the proposals to better meet the objectives outlined by Ofgem as part of the price review. We are however, concerned that a significant amount of work is still required on the detailed design of adjustment mechanisms and incentives. The overall acceptability of the proposals therefore remains highly dependant upon the proposals being amended to be more in line with the objectives set out at the beginning of the price control and further progress being made on detailed design of the adjustment mechanisms and incentives.
- 4 In advance of setting out our more detailed comments on the latest proposals for gas and electricity, we set out below our generic concerns and proposed solutions associated with the current proposals:
  - (a) The proposed UCAs (where currently specified) do not represent a reasonable ex-ante view of investment costs. This issue becomes more material given the proposal to increase National Grid's exposure to the difference between UCAs and actual costs.  
  
Proposed Solution: The UCAs should be amended to reflect a reasonable ex-ante view of costs.
  - (b) We are concerned about the level of exposure Ofgem are proposing in relation to the incentives around UCAs (25% in electricity and higher in gas). The proposals to increase the exposure on UCAs are inappropriate, especially given the experience in the current price control and the uncertainties in the period being considered.

Proposed Solution: The incentives on UCAs should be reduced to 10% (upside and downside), in line with our view on the appropriate sharing factor for all deviations of actual capex (load or non-load) from price control assumptions.

- (c) The proposals for the new gas investment incentive represent a large downside risk (£72m pa) with no realistic upside. This is highly material and is not reflected in the cost of capital proposals.

Proposed Solution: The proposals should be amended to provide rewards commensurate with the risks and, in any event, the total exposure should be substantially reduced. Specific proposals are contained in this Appendix.

- (d) Uncertainty remains on the proposed gas entry baselines. We would continue to highlight that if Ofgem were to set baselines above the current system capability (as detailed in the Initial Proposals document) then this would be likely to trigger significant buyback exposure to customers under certain supply scenarios. This would seem inconsistent with the Ofgem objective of developing a network with an appropriate degree of flexibility. It would also undermine the user commitment model and the transfer mechanisms being proposed by Ofgem.

Proposed Solution: We believe the zonal analysis produced by National Grid best represents the physical capability of the system and therefore best meets Ofgem's objectives.

- (e) The proposed timing of incentive-driven cash flows in gas could exacerbate financeability issues. The proposals concerning the timing of revenues for electricity, together with the defined constant incentive exposures, should therefore be applied to gas. This would have the additional benefit of providing some regulatory consistency and removing the complexity of the current gas proposals which would plausibly expose National Grid to the difference between UCAs and actual costs to 2019 or beyond.

Proposed Solution: The incentive mechanisms being proposed for electricity should also be applied to gas (subject to our comments above and below on the appropriate sharing factors for deviations from price control assumptions).

- (f) There is a general lack of any upside in the proposed incentives which is either explicit in terms of the electricity system performance incentive or implicit in terms of the new gas investment incentive and the CLNG proposals. We are concerned that to date we have seen no concrete proposals on the electricity Transmission Network Reliability Incentive (TNRI), other than the intention to make it a penal only scheme.

Proposed Solution: Incentives should be amended to have an appropriate balance of risk and reward and should be consistent with whatever capex

allowance is finally decided. Where proposals have not been fully developed (e.g. TNRI) more details should be provided in advance of Final Proposals.

- (g) We are concerned about the lack of progress that has been made on the proposals for LNG funding and Operational Buybacks.

Proposed Solution: Further work is required to develop the proposals in advance of Final Proposals. We cover the LNG issue in Appendix 6 attached.

- 5 In summary, the current proposals are unacceptable to us in their current form as they would significantly increase the risks without the prospect of rewards commensurate with those risks. We would suggest further dialogue with Ofgem takes place on our proposed solutions as soon as possible.
- 6 In the following sections, we deal successively with the issues which we see as arising in respect of:
  - (a) gas entry;
  - (b) gas exit; and
  - (c) electricity.

## Gas entry

### Overview

- 7 The section below highlights our views on the current proposals relating to **UCAs, Baselines** and **new investment buybacks**. Whilst we are pleased that Ofgem have stated that they are still proposing to set baselines and funding for new investment through UCAs at levels consistent with physically accommodating flows under a wide range of scenarios and with the expectation of buy back risk being residual and relatively low, we remain concerned that we have not currently seen a set of proposals that meet that desired aim. We also remain concerned that the proposed new investment buyback scheme fails to meet a key theme of the transmission price control, namely to provide rewards for the companies commensurate with the risks they face. We give a description of the main issues with the current proposals and a suggested way forward on each of the issues.

### UCAs

#### Issue

- 8 As mentioned above, we are pleased that in the September document Ofgem have stated that it seems reasonable that our revenue drivers should enable NGG NTS to fund investment for new demand to such an extent that they do not

lead to significant additional buyback costs under the same wide range of flow scenarios assumed in setting baselines<sup>1</sup>. Ofgem also recognise that, arguably, their proposed revenue drivers in the June document do not enable this, as NGG NTS would not receive sufficient funding to accommodate new demand under a supply scenario with higher than average investment costs. In addition, we have not been able to replicate the proposals for revenue drivers contained in both the Initial and Updated Proposals. Subsequent contact with Ofgem has highlighted an error in Ofgem's calculations.

### Proposed Way Forward

- 9 We believe further work should be undertaken on both the National Grid Proposal and the Alternative Proposals outlined in the Updated Proposals document to see which methodology is most consistent with objective of buyback risk being residual and relatively low.

### Issue

- 10 The latest proposals continue to be that the UCAs are fixed at the beginning of the price control for the full duration of the price control. As previously stated, this remains unacceptable for the following reasons:
- (a) **Changing supply patterns.** As recognised in recent Ofgem consultation documents<sup>2</sup>, it is clear that there have been significant changes in gas flow patterns over the current price control period which have led to UCAs becoming non cost reflective towards the end of the price control period. The current proposals contain the same risk that UCAs, set with the intent of being cost reflective as part of a price control, become non cost reflective during the price control period. This becomes increasingly important given the proposals on rolling incentives set out below.
  - (b) **Pricing pressures.** As recognised in recent Ofgem consultation documents, the price of steel has increased significantly and the contract market has tightened. Neither of these factors has been taken into account in the current proposals for setting UCAs.
  - (c) **Inconsistency with Ofgem's (in our view, correct) policy on setting future prices for new entry capacity.** In their recent decision document on UCAs for large new entry points<sup>3</sup>, Ofgem describe the benefit of there being an opportunity in the future for "entry reserve prices to be updated

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<sup>1</sup> Paragraph 1.25 of Appendix 9 – Gas Entry Incentives

<sup>2</sup> Adjusting National Grid's revenue allowances when large new entry points connect to the gas transmission system, 29 March 2006.

<sup>3</sup> Determining Unit Cost Allowances (UCAs) for large new entry points & Section 23 notice for Fleetwood, 13 July 2006

for new cost information more frequently during the price control period than at present” (when the prices are, in effect, fixed for the whole of the price control period). We agree with Ofgem on this benefit. However, it is hard to understand why it should be a benefit for **prices** to be updated in the light of new cost information (including the impact of changes in the view on likely future patterns of gas supply and demand) but **not** a benefit for revenues to be updated in the same manner.

- 11 The problems caused by setting the wrong UCAs and by setting them for the whole of the price control period would be substantially exacerbated by the proposed introduction of a five year rolling incentive in respect of the UCAs. In essence, it is being proposed that we should be exposed to the difference between UCAs and actual costs for five years from contractual delivery of the capacity in question. What this would mean, for example, is that, if new capacity was purchased in the long term capacity auctions in, say, September 2011 for delivery in October 2014, then we would be exposed **through to 2019** to UCAs which will be incorrect even when they are set in 2006. In our view, this would make no sense or would, at the very least, be inconsistent with the sort of risk profile which has thus far underpinned consideration of NGG’s cost of capital.

### **Proposed Way Forward**

- 12 We believe the issues detailed above could be addressed as follows:
- (a) The issue of **pricing pressures** could be addressed by either a fixed additional allowance (at a premium to the mean expectation of future price movements) or some form of price indexation. We would highlight that Ofgem have already approved a methodology for price indexation within the IECR Methodology Statement.
  - (b) The issue of **changing supply patterns** and the **inconsistency with Ofgem’s policy on future prices for new entry** is addressed by either:
    - (i) re-opening UCAs in the wake of the relevant capacity auctions if supply patterns (as suggested by the auctions) suggest that the efficient level of investment is at least 10% more than the capital cost implied by the UCA set as part of the price control process. In this way, we would be more likely to be incentivised to beat a reasonable ex ante estimate of efficient costs (estimated at a point when more of the relevant information will be available than it is now); or
    - (ii) introducing an adjustment mechanism to limit the difference between actual capital costs and revenue driver allowances to a maximum of 10% (in line with our overall proposal on the appropriate sharing factor for deviation of actual spend from price control assumptions).
  - (c) We would propose the issue of National Grid being exposed to the difference between UCAs and actual costs to 2019 or beyond is

addressed by adopting Ofgem's proposals for electricity revenue drivers, including fixing a given factor for sharing the differences between UCAs and actual costs. Given the potential size of spend on entry developments in the next price control period and the potential financeability issues relating to gas transmission, we would also propose that the cash flow mechanisms proposed for electricity are also adopted for the gas arrangements.

- 13 We note that Ofgem are still considering the unit cost assumptions underlying the revenue drivers. We believe the issue of unit costs needs to be addressed consistently across both gas entry and gas exit and across the revenue allowed for baseline investments and revenue driver investments. Further work is required to gain this consistency before Final Proposals.

### **Baselines**

- 14 We are pleased that Ofgem have stated in the September document that "we intend to set baselines at a level consistent with physical accommodation of possible flows under a wide range of scenarios across entry points. This means that we intend to set baselines such that exposure to (operational) buy back risk will be residual, and relatively low"<sup>4</sup>.
- 15 We remain concerned, however, that we have not currently seen a set of proposals that meet that desired aim. We hope that analysis provided by National Grid has identified that Ofgem's earlier proposals have not adequately taken into account the interactions between nodes as they have been set on the basis of analysis considering each entry point in isolation. We believe the analysis has also highlighted that the free increments have been counted several times and therefore system capability has been greatly over stated. Clearly, baselines will need also to be consistent with any conclusions Ofgem eventually reach on compressor station closures.

### **Proposed way forward**

- 16 We believe Ofgem should set baselines in line with the zonal capability analysis provided by National Grid as we believe this is in line with Ofgem's stated policy intent. If baselines were not adjusted in line with our proposed zonal methodology, then we would be obliged to release capacity beyond system capability which would expose customers to potential very high buyback costs<sup>5</sup>.

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<sup>4</sup> Paragraph 1.9 of Appendix 9 – Gas Entry incentives

<sup>5</sup> Although National Grid currently has an incentive on Buybacks, these arrangements expire on 31 March 2007 and therefore, in the absence of new arrangements being agreed, customers would be exposed to 100% of buybacks.

## **New Investment Buyback Incentive**

- 17 Whilst Ofgem have modified the proposals since the Initial Proposals document, the current proposals relating to new investment buybacks remain totally unacceptable and do not meet Ofgem's aim of ensuring that there should be an appropriate balance of risk between the transmission companies, network users and consumers. The current proposals continue to fail Ofgem's stated aim of providing rewards for the companies commensurate with the risks they face. Our concerns with the current proposals and a proposed way forward are set out below:

### **Issues with the current proposals**

- 18 The main issues with the current proposals are that, although less punitive than the Initial Proposals, the proposals fail to provide an appropriate balance of risk and reward for the following reasons:
- (a) There is no realistic upside for taking on a £36m pa exposure on gas entry (£72m pa including gas exit), especially given the proposed lead times.
  - (b) The proposals are inconsistent with overall base rate of return (for NGG NTS, 100 basis points on rate of return equate to around £30m pa through the next price control period).
  - (c) We can see no justification for increasing the buyback exposure for capacity released during this price control, from the current £12.5m exposure. Keeping the buyback exposure at the level that existed when the capacity was released would be consistent with Ofgem's proposals for shippers.
  - (d) Although further work is required on the concept of permits the risk of hitting the collar is deemed high given that National Grid would only need to be late on 1 major scheme per year for 11 days before hitting the collar (650GWh/d X 0.52p = £3.38m per day). Hitting the collar in such a short space of time would remove the value of the incentive for the rest of the year (as recognised in the recent Ofgem proposals on Milford Haven).
  - (e) We currently have insufficient comfort that the default timescales are adequate (42 months is an insufficient default timeline given the current timing of the September auctions and the inability to construct over winter).
  - (f) We do not believe that permits should be used to correct the average default timeline. It should also be noted that we currently have insufficient information to ensure that there will be sufficient permits to deal with other issues such as consent/local planning issues and 2 year construction builds.

- (g) We do not believe the proposals take any consideration of the realistic terms we can enter into with our contractors. We believe Ofgem should consider the likely premium that would be applied if our contractors were being asked to bear this level of financial risk.
- (h) We believe further work is still required to exclude events which clearly fall outside the default timeline (e.g. local planning appeals or appeals to Dti consent).

### **Proposed Way Forward**

- 19 The proposed way forward examines both the risk and reward aspects of the current proposals - the aim being a set of proposals that provide rewards for the companies commensurate with the risks they face. In order to achieve an acceptable balance of risk and reward (i.e. high risk/high reward or low risk/low reward) we believe the following changes should be considered.
- (a) The absolute potential exposure (£m): We believe National Grid's exposure should remain at £12.5m per annum for capacity released in this price control period.
  - (b) Default timescales: Default timescales should be set at 48 months to recognise 42 months is insufficient time given the timing of the September auctions and the inability to construct over winter. This has the additional benefit of reducing the importance of permits – a process which has yet to be defined in the current proposals.
  - (c) Monthly collars: Monthly collars should be incorporated to provide a more appropriate risk profile and ensure the incentive remains active throughout the year (as per the Ofgem Milford Haven proposals)
  - (d) Exposure over winter: We believe the monthly collars should take into account that National Grid cannot build pipelines over the winter period. Incentive exposures should therefore be frozen over the winter period.
  - (e) Exclusions: We remain of the view that certain events which clearly fall outside of the default lead times, and are outside National Grid's control, should be the subject of an exclusion from the incentive scheme (e.g. planning appeals and Dti consent appeals). Re-openers for changes in legislation should also be incorporated given the current Government review.
  - (f) In terms of an appropriate reward for taking on the risk, we believe the options of rewarding timely delivery and reward for early delivery should both be considered further. We believe the option of rewarding early delivery through the potential sale of incremental non-obligated capacity would only have any credibility if Ofgem set a default timeline of 48 months.

- 20 The section above has considered our current issues and the proposed way forward on the proposals relating to baselines, UCAs and new investment buybacks. Our comments on the other main elements contained in the consultation document are considered briefly below:

### **Operational Buybacks**

- 21 We believe that significant work is still required to agree an appropriate operational buyback incentive. We have presented our initial views to Ofgem for 2007/8 and look forward to further dialogue once the baselines have been agreed. In advance of this dialogue, we think that it is premature to propose that the downside sharing factor should be increased to 50% and the caps and collars increased to £36m.
- 22 We would also appreciate confirmation from Ofgem on the timescales and process associated with setting the Operational buyback incentive, given its relevance to the acceptability of the TO proposals.

### **Treatment of capacity release obligations and capacity substitution**

- 23 In our response to the Initial Proposals document we suggested that further work was required to ensure all the details and implications of moving to a regime involving substitution of capacity were fully understood. On the basis that Ofgem have recognised the points raised in our earlier response; such as the likely impact on customers who rely on short term release of capacity (such as storage operators and LNG), a likely increase in operational buybacks (as it will transfer capacity from nodes where there was an ex-ante expectation that gas would not flow to a node where gas is more likely to flow) and a general increase in complexity, then consideration will now need to focus on timescales for delivery and funding for these new obligations.
- 24 In relation to the timescales for delivery, National Grid has recently proposed UNC modification 0118 to introduce a degree of substitution of capacity. We believe that this is likely to be the maximum achievable by the start of the price control period. Clearly costs associated with these new obligations and the potential costs associated with more complicated models should be considered as part of the price control.
- 25 Under any model we believe National Grid should be remunerated for undertaking its obligations. We therefore would not support Ofgem's suggestion that any charge levied on a shipper could be subsequently netted off the charges for the capacity. Although this may have desirable properties for the shipper it would not fund National Grid's activities.

### **User Commitment and the link to Investment**

- 26 In our response to the Initial Proposals we highlighted our concerns regarding our remuneration in situations where it was considered to be efficient to 'over build' capacity relative to the immediate demand for capacity as revealed in the long

term capacity auctions. Whilst we recognise the points raised by Ofgem in the September document<sup>6</sup> we have some concerns that the proposals may further increase complexity and potentially costs.

- 27 Given any proposal from National Grid would need to be approved by Ofgem we would still support a mechanism that was codified as part of the price control. In the event that Ofgem reject that proposal we will be forced to use the *ad hoc* process suggested by Ofgem, which will need to be assessed on a case by case basis.

## Gas Exit

### Overview

- 28 The section below highlights our views on the current proposals relating to **UCAs, baselines, new investment buybacks and CLNG**. We give a description of the main issues with the current proposals and a suggested way forward on each of the issues.

### UCAs

#### Issue

- 29 The proposed UCAs do not represent a reasonable ex-ante view of investment costs. This issue becomes more material given the proposal to increase National Grid's exposure to the difference between UCAs and actual costs. We believe there are two fundamental reasons for the inadequate allowances – the views being taken on the **unit costs** and the **design of the revenue driver** in relation to the South West Quadrant. These items are considered below:
- (a) In relation to **unit costs** we are disappointed that Ofgem have decided to ignore the views of the original capex consultant (TPA) and instead rely on a report from a second consultant (Penspen), who have not been involved in the price control process over the last year. Having received the consultants report from Ofgem on 3<sup>rd</sup> October we have responded to Ofgem expressing our concerns over both the process and the analysis. We have chosen not to repeat the concerns in this response but would welcome further discussions with Ofgem on our separate response to the Penspen report.
  - (b) In relation to the **design of the revenue driver** in the south west quadrant, we remain concerned that the revenue driver will not adequately fund the efficient level of investment. Designing the revenue driver to be based purely on user commitment, rather than the minimum

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<sup>6</sup> Paragraph 10.31 of Chapter 10 of the Updated Proposals – Adjustment mechanisms and incentives: gas

efficient investment that is triggered by the user commitment, will have material impact on our rate of return on the investment.

- (c) Finally, there is currently no clarity on the level of user commitment required to trigger the revenue driver (unlike the proposals for electricity). We believe this clarity should be provided in the Final Proposals document.

### **Proposed Way Forward**

- 30 First and foremost we request that Ofgem consider the information provided by National Grid over the past month on both the issue of unit costs and the design of the revenue driver. In relation to the design of the revenue driver in the South West quadrant we believe Ofgem should amend the UCA to adequately fund the minimum efficient investment triggered by the user commitment.
- 31 In relation to the link between user commitment and the trigger for the revenue driver, we would propose that the licence is explicit that the revenue driver is triggered upon receipt of the appropriate user commitment as specified in the Exit Capacity Release Methodology statement.

### **Baselines**

- 32 We note that Ofgem's proposals in the September document remain unchanged relative to the Initial proposals consultation. Whilst we acknowledge that Ofgem are proposing an allowance to recognise that the capacity released will be above the system capability, we believe this is ultimately increasing costs to consumers beyond the alternative scenario which would set baselines for interruptible customers in the South West to zero, in line with the current capability of the system.
- 33 Assuming there is no change in the proposals, we believe further work is required on the appropriate level of funding. We do not believe that using an allowance based on CLNG (which is still subject to change as part of the ongoing discussions on LNG funding) is an appropriate basis for an enduring solution. Given the enduring nature of baselines we believe that it would be more appropriate to set an allowance based on the cost of investment rather than the cost of CLNG.
- 34 We would support Ofgem's proposal to set a flexibility baseline at the national level of 22mcm/day for each year of the enduring Offtake period. We would also support further discussions on a potential incentive on NGG NTS to release incremental flexibility over and above the flexibility baseline.

### **New Investment Buyback Incentive**

- 35 We would refer Ofgem to the comments made in relation to gas entry as they are equally relevant to gas exit. In particular we would highlight that the default timescales should be consistent across entry and exit, given we are installing the

same types of assets (pipeline and compressors). We do not believe that the 38 months currently planned between the first exit auctions and the enduring exit regime commencing in October 2010 to be relevant as we have had no scope to change the delivery date for enduring exit.

- 36 We would appreciate confirmation from Ofgem as to whether the new investment buy back incentive only applies for exit capacity delivered from 1 October 2010.

## **CLNG**

- 37 As mentioned in our response to the Initial Proposals document, we believe that further work is required on setting targets for CLNG not least because of the interaction with the price control discussions on LNG funding.
- 38 Following recent discussions with Ofgem, we believe we are in broad agreement with Ofgem on the volume requirement in relation to the medium case and high case and believe we have valid reasons to discount the underlying assumptions behind the low case.

## **Transitional Offtake incentives**

- 39 Our views remain unchanged from our response to the Initial Proposals document, namely that whilst we broadly agree with the content of Ofgem's initial proposals in respect of the incentives to apply in the transitional period, we disagree with Ofgem's proposals in relation to >15 day interruption incentive and the removal of the NTS buyback incentive.

## **Electricity**

### **Overview**

- 40 This section gives our views on the proposed form of the NGET price control and the incentives that arise.

### **Capital Investment Incentives**

- 41 The proposals would use an ex-post adjustment of revenues to provide a constant incentive to seek capital efficiencies irrespective of whether the ex-ante allowance is over or under spent, and irrespective of whether the investment occurs earlier or later in the price control period. The proposed strength of the incentive represents 25% of the difference between actual capex and the price control allowance.
- 42 We agree with Ofgem that it is desirable to have incentives that are free from periodicity effects or bias. The proposed one-off adjustment to give a constant exposure would be less complex and more predictable than rolling incentives and so would be preferred. However, a 25% exposure is much larger than has been

experienced in previous controls and would give rise to particular concerns given future uncertainties.

- 43 A 25% exposure would be larger than the theoretical average incentive NGET has faced in previous 5 year controls (17.9%) and significantly larger than the exposure to overspend we have actually faced (given that overspends are most likely to occur towards the end of the price control). Our calculation of the exposure for overspends are summarised in the following table:

**Exposure under 5 year RPI-X price control**

Exposure for overspend in 1st year	31.61%
Exposure for overspend in 2nd year	25.30%
Exposure for overspend in 3rd year	18.46%
Exposure for overspend in 4th year	11.07%
Exposure for overspend in 5th year	3.06%
Average exposure for overspend in all 5 years	17.90%
Average exposure for overspend at end period (yr 4 & 5)	7.07%

(These are based on receiving, for years after the control in which overspend occurs, a depreciation allowance of 1/40 of the capital investment and a return of 6.25% real pre-tax on the average of opening and closing RAV.)

- 44 Overspend is most likely at the end of the price control because these years are most distant (and hence most susceptible to forecasting error) when price control forecasts are made. (This effect can be observed in our profile of overspend and when actual investment unit costs and volumes departed from the expectations at the last price review.)

**Proposed Way Forward**

- 45 On the basis of our calculations we suggest that a suitable exposure consistent with exposures under past price controls would be 10%.

**Ex-post adjustments**

- 46 A fixed exposure to both under and over spend implies that other ex-post adjustments to reflect actual investment unit costs or actual required volumes will tend not to be made except in certain exceptional circumstances. While the proposals concentrate on the treatment of over and under spend relative to the

allowance, they are not clear on the nature of our obligation to deliver investment outputs. It will difficult to accept proposals on asset replacement funding in the absence of clarity as to what we are expected to deliver in return for that funding. Ofgem's proposals could be consistent with our obligation being any one of the following:

- (a) spend the 'allowance' as efficiently as possible, with delivered outputs being whatever they will be;
  - (b) deliver a specified volume of investments with the fixed exposure to any difference between actual cost and an allowance based on agreed unit costs; or
  - (c) undertake investments necessary to deliver what, in our view, would, on a sustainable basis, be an appropriately reliable network.
- 47 Of the above, (a) implies that any future price review will focus totally on spend, whereas (b) and (c) would, in different ways, link revenue beyond 2011/12 to outputs delivered through the next price control period. On the basis of discussions to date, (c) would, of course, imply the need for rather more revenue than either (a) or (b).

#### **Proposed Way Forward**

- 48 We need greater clarity within the Final Proposals on how Ofgem see our obligations in relation to the development and maintenance of the transmission system working in practice.

#### **Significant capex Under Spends**

- 49 Ofgem propose that, in addition to a generally symmetrical exposure to under and overspend spends, there should nevertheless be a provision which deals with the risk that companies could unduly cut capital investment from the levels underlying the new price controls. It is suggested that a price control re-opener might be triggered if, for example, cumulative under-spend within a price control period was more than 20% of the cumulative capex allowance.

#### **Proposed Way Forward**

- 50 At this stage in the price review process, and in the context of the Updated Proposals, we cannot envisage circumstances in which we would be under-spending at all, let alone the sort of under-spend which Ofgem envisage. From this angle, the proposed 'safety net' would seem to be somewhat academic, as well as being obviously asymmetrical.
- 51 To some extent, our view on this issue comes back to the issues which we raise above about the nature of our obligations to deliver outputs, as against our incentives to incur capital spend. Clarity on this area would make it easier to appraise the generality of Ofgem's proposals for dealing with under-spend and over-spend relative to Ofgem's proposed capex allowances.

## Load Related Adjustment Mechanisms and Incentives

- 52 The proposed difference in form between SPTL/SHETL and NGET controls is proposed on the basis of different exposures to sample risk. For deeper reinforcement costs, where SPTL and SHETL are reported to have a limited number of discrete reinforcement schemes, this would appear to be different from National Grid's position where reactive compensation and other network up-rating can be varied more continuously as requirements demand.
- 53 On local connection costs, the issue concerning price uncertainty for SPTL and SHETL is reported to be due to location rather than number of schemes (which given the number of wind generator applications would appear to be of a similar order if not higher than those requested from National Grid). National Grid's proposed form of revenue drivers makes some account of locational issues by grouping connections into zones of similar connection characteristics. While we are not able to comment on the feasibility of using such an approach in Scotland, we agree that, qualitatively at least, a difference in treatment might be justified. However, we do not agree that such a difference would justify the omission of a cost re-opener mechanism for NGET (see above).
- 54 We agree that having part of revenues conditional on delivery of load-related outputs provides a good compromise between incentives to deliver outputs and exposure to the risk (much of which is outside our control) that investments are initiated on the basis of information that in retrospect may prove to be inaccurate or incomplete. The need for this compromise is particularly important because National Grid's revenue driver formulation is likely to take into account demand and generation changes (i.e. in zonal surplus and deficits measurements) which are not fully or directly covered by customer financial commitments.
- 55 We agree with Ofgem that there is good reason for the proportion of revenues that are conditional on delivery, the proportion of revenues that are set by a pre-determined UCA and the capex exposure factor proposed in Chapter 7 are all the same. This gives consistent incentives with respect to seeking capital efficiencies and also sets an objective basis for deciding when adjustments should be made. (As noted above, however, we do not think a 25% exposure is consistent with past price controls or appropriate given future uncertainties.)
- 56 We suggest, however, that the complexity and specific requirements for regulatory oversight of a 'revenue driver RAV' mechanism can be avoided by using an alternative formulation of the Chapter 9/Appendix 8 incentives such that they can be integrated in the proposed Chapter 7/Appendix 10 mechanism. This would remove any actual or perceived scope for obtaining short-term advantages by selectively reporting investment in the load related or non load related categories. It would also permit UCAs, base scenario allowances and base scenario volumes to be reset for the next price control period in a synchronised and consistent manner. Such a reformulation would mean that revenues would not be fully or even partially adjusted as load related capital investment is incurred but all or most of the adjustment would take place at the end of the control when the Chapter 7/Appendix 10 mechanism is applied. We consider that loss of the 'as incurred' adjustment would be acceptable provided that the base

scenario load related allowances are such that they are likely to satisfy financing requirements.

- 57 The revised formulation would comprise:
- (i) Revenues under the RPI-X control to finance allowed non load related investments and the load related investments consistent with the base scenario.
  - (ii) An ex-post adjustment (as set out in Appendix 10) which makes a revenue adjustment that exposes us to X% of the difference between actual capex (load and non-load related) and that allowed in 1).
  - (iii) An additional exposure to X% of the load related UCA for the difference between actual delivered volume and that anticipated in the base scenario.
- 58 The load related volume adjustment (part 3 above) means that, if we incur additional spend at a unit cost matching the unit cost allowance, then we would be held whole. Otherwise, and more generally, for each unit of incremental or decremental volume from the base scenario we will be exposed to X% of the difference between actual unit costs and the corresponding unit cost allowance.
- 59 It is for consideration whether the suggested part 3 adjustment should be made 'as delivered' or ex-post along with part 2 as proposed in the Appendix 10 mechanism. **If the base scenario volumes and allowance are a reasonable central forecast** then we would be less concerned about having this adjustment made at the end of the price control.
- 60 We welcome Ofgem's approach of defining a central base scenario about which unit costs can be assessed. This approach ensures that interactions between entry and exit related investments (e.g. approximations concerning the substitutability between nodes), together with investments that are already initiated prior to the introduction of revenue drivers, can be correctly covered.

### **Proposed Way Forward**

- 61 To minimise complexity and some potential for perverse incentives, we recommend a revised formulation of Ofgem's mechanisms to implement the proposed incentives. We agree with Ofgem that the strength of the load related capex incentive should be the same as for the non loaded related investments but suggest that a value of 10% is more consistent with past incentive strengths and better reflects uncertainties now arising in the equipment supply market.
- 62 We look forward to finalising the design of revenue driver mechanisms and associated unit cost allowances in the near future. The establishment of a reasonable central forecast in the base scenario will reduce the financing requirements for 'as incurred' adjustments, enable a single comprehensive and

consistent ex-post adjustment, and minimise the consequences of insufficiently accurate representation of investment needs and costs by revenue drivers.