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Dear Robert

Transmission Price Control: Updated Proposals

EDF Energy welcomes the opportunity to respond to Ofgem's updated proposals for the next transmission price control review. This response can be published on Ofgem's website. We deal first with high-level financial issues, and then with specific questions in the attachment.

We are pleased to see that Ofgem has recognised that its decision on the cost of capital needs to take account of a range of factors, including the investment focus of the review, the need for financeability, commercial risk, the work of its consultants and, crucially, consistency with past regulatory decisions. We agree that these are the most important factors involved in setting the regulatory cost of capital.

We are not commenting on the detailed estimates of core CAPM parameters set out in Smithers' report because we do not believe that further academic analysis would facilitate the regulatory judgments now required. In particular, we see Smithers' contribution as a useful addition to the previous work of other academics and regulators, but not as one which particularly deserves to carry additional weight. We note that Smithers' range for the cost of capital (3.9% to 5.35% real post-tax WACC) does not exclude the WACC used for the purposes of DPCR4 even though it assumes an unprecedented reduction in equity betas from 1 to just 0.5.

Ofgem's use of a 4.2% real post-tax cost of capital as its modelling assumption for the TPCR, to the extent that this implied a significant cut from the 4.8% used for DPCR4 just 30 months ago, seemed to signal a disturbing possibility that regulatory consistency might now be seen as less important. Such an outcome would, in our view, be highly damaging to a sector where investors are likely to be asked, for the indefinite future, to fund the extension to and replacement of ageing infrastructures which are central to meeting the government's energy policy objectives. We are therefore pleased to see Ofgem explicitly referring to the importance of consistency. As a result, we are more confident that Ofgem will make the correct choices when formulating its final TPCR proposals.

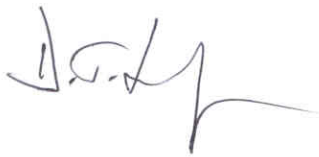
We support the assumption of new equity injections when assessing financeability and we are pleased that Ofgem has recognised the need to make allowances for issuance costs. The mechanisms for funding these costs must not distort the choice between retained earnings and new equity, which is a decision for the companies alone. It should also take into account the "announcement" effect identified in the Smithers report, although, given the likely uncertainty about the size of this effect in the regulatory context (particularly as the markets adjust to the

idea of rights issues as business as usual rather than as signs of distress), we recognise that it would be difficult to make an ex-ante allowance for this. We therefore propose an ex-ante uplift to the cost of equity (within the WACC) to cover issuance costs (including any underwriting expenses), plus an ex-post adjustment for any observed announcement effects. The ex-ante uplift for issuance costs would not be adjusted ex-post as it would be important not to distort retained earnings decisions.

Ofgem has not published the financial ratios used to assess the financeability of transmission companies, thus removing the opportunity for us to comment. In our view, this is not good regulatory practice. We are also concerned that Ofgem has proposed expenditure levels (in certain circumstances) significantly below those forecast by the licencees themselves. In particular, we note that Ofgem's proposed non-load-related allowance for NGET is some £669m (27%) below the NGET forecast. Such a significant divergence of views appears to indicate a fundamentally different approach to the modelling of future requirements. The underlying reasons for such divergence clearly need to be understood.

I hope that our comments, both above and in the attachment, will be helpful.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford'.

Denis Linford
Director of Regulation

Transmission Price Control: Specific Questions in the Updated Proposals

Question 10.1: Do you agree with our proposals for the treatment of entry and offtake capacity release obligations and capacity substitution?

We agree with the proposal to reduce the proportion of entry capacity held back from the long term auctions from 20% to 10%, with an intention to remove the concept completely as part of the next price control review. However, we recognise that these proposals have to align with the EU Directives which stipulate that a certain amount of capacity needs to be held back for new entrants, so Ofgem's final proposal will need to comply with this.

Offtake Capacity – given Ofgem's intention not to fetter the Authority's discretion regarding its decision on modification proposal 116, which introduces the concept of flat and flexibility capacity, we find it very surprising that Ofgem is consulting on the levels of baselines for flat and flexibility capacity within this consultation.

Capacity Transfers – In general, the stated principles for capacity transfers and trades seem reasonable. However, the introduction of these mechanisms will add complexity to the current arrangements. It would therefore be beneficial if Ofgem were to conduct an impartial impact assessment to identify the costs and benefits associated with these reforms before it finally decides to implement them.

Question 10.2: Do you agree with our proposed approach in relation to revenue drivers?

At a high level, Ofgem's desire to introduce a second opportunity for shippers to book additional capacity following the LTSEC auctions to accommodate the issues surrounding the low cost of over-build is concerning. This appears to reflect Ofgem's insatiable appetite for auctions and complexity, when simplicity and transparency are generally preferred by the market. It would be more equitable to allow NGG to over-build capacity without regulatory interference provided that the cost associated with this was marginal. For example, over-build could be allowed without a re-opener provided that the additional cost of the investment was within X% of the total cost.

Question 10.3: What are your views of our proposals on buy-back incentives, in particular in relation to investment lead times and caps on exposure?

The differentiation between buy-backs associated with late delivery of investment and those associated with operational issues appears reasonable, reflecting NGG's ability to manage these risks. While the increase in investment lead times for entry capacity to 42 months is a welcome improvement on the current 36 months, it could be questioned how this figure was reached when it appears that generally the investment lead time now is closer to 48 months. This can be seen most clearly from the recent consultations that increased the investment lead time at both Milford Haven and Easington to 48 months.

It may therefore be more appropriate to increase the default lead time to 48 months, reducing the buy-back costs to shippers and therefore consumers while providing increased confidence to those who have purchased entry capacity that it will be delivered on time. With the exit default lead time of 38 months, it could be questioned how suitable this is, given the problems that NGG has encountered in delivering entry capacity within a similar timeframe. It will therefore be useful if Ofgem can provide more information on how this lead time was reached.

The introduction of so-called trump cards for investment delivery is a novel idea, but it must be questionable whether this will deliver a better solution than adopting more appropriate lead times. Also, while placing a cap on the offers that shippers can make for selling capacity back to NGG will ensure that NGG's and customers' costs are reduced, it should be noted that any

cap will be an arbitrary figure and may not reflect the true cost to the shipper of NGG failing to deliver investment capacity on time. This will represent a risk to shippers, as they would have stranded assets, be unable to ship gas, and would be capped on the level of compensation that they could receive. This could have implications for security of supply and appears to fly in the face of the principles behind entry capacity auctions that were designed to reveal the value of incremental capacity to NGG, providing an investment appraisal tool.

It may therefore be more equitable if no cap is placed on shippers' offers to sell capacity back to NGG. The threat of an investigation into abuse of a dominant position would help to ensure that buy-back costs were based on the opportunity cost to the shipper, though the threat of this would need to be real to provide an adequate incentive.

It must also be questioned why Ofgem has decided to introduce a cap of £36m on buy-back costs associated with investment delivery, given that NGG is best placed to manage these risks. In the past, Ofgem has stated a strong desire to ensure that those best placed to manage risks are also exposed to them, yet it has decided to transfer the risk that NGG is unable to deliver capacity on time from NGG to shippers and consumers, who are unable to influence, let alone manage, these risks. It should further be noted that these annual caps also appear small, given the recent £26m buy-back cost incurred at St Fergus over a three-day period.

We therefore urge Ofgem to scrap the cap and investigate the buy-back auctions that took place at St Fergus, given that NGG appears to have evidence that some shippers were purchasing entry capacity in the day-ahead auction to sell back to NGG the following day at highly inflated prices. This seems a prima facie abuse of dominance that should be investigated fully.

Question 10.4: Is it appropriate to propose an incentive on NGG NTS to release additional incremental flexibility over and above the flexibility baseline?

As we mention above, it is not clear why Ofgem is consulting on this in the context of this price control consultation. But if modification proposal 116 were to be implemented, in the face of strong industry opposition, then Ofgem's proposals to incentivise the release of the incremental flexibility capacity seem appropriate. However, given that only 22mcm/day of flexibility can apparently be attributed to system design, and so to NGG, with any incremental capacity being attributed to shippers and offshore producers, we question how NGG will be purchasing this service if they are receiving a benefit from it.

Question A7.2: Do you agree with our updated proposals for the enduring period with respect to:

- (3) The treatment of interruptible sites in the SW quadrant.** One of the core principles behind Ofgem's desire to implement exit reform, despite industry opposition, was the introduction of equitable, non-discriminatory treatment of all offtakes from the NTS system. It is therefore not clear why Ofgem has singled out interruptible sites in the South West quadrant for special treatment. If the NTS is configured in such a way that certain sites, and offtakes, need to be treated differently, then serious questions will need to be raised about the appropriateness of NTS exit reform.
- (4) Revenue drivers.** As discussed above, the use of specific revenue drivers for projects in the South West quadrant raises serious concerns about the appropriateness of the NTS exit reforms. If it is appropriate to apply different revenue drivers to different quadrants within the NTS, then it would also be appropriate to apply an exit regime that reflects these differing requirements.