



Transmission Price Control Review – Initial Proposals Response by Association of Electricity Producers

24 October 2006

Introduction The Association welcomes the opportunity to comment on Ofgem's updated proposals for the 2007 Price Control Review. The Association of Electricity Producers (AEP) is the UK trade association representing electricity generators. It has some 90 members ranging from small firms to large, well-known PLCs. Between them they represent at least 90 per cent of the transmission connected generating capacity and they embrace nearly every generating technology used in the UK. Many member companies have interests in the production and development of renewable energy where the government has set ambitious targets for development over the next decades.

Our response to the consultation document falls into two parts: general comments and then detailed comments that follow the layout of the questions posed within the document. The question is posed in italics and our response in normal font.

GENERAL COMMENTS

The Association recognises that this price control is of particular strategic importance to GB as it sets an approach to capital investment in transmission assets that should underpin significant new build, as well as retirement of existing plant. Over the period of this Price Review and the next, we anticipate that the balance of generation technologies will shift. For these reasons, we believe it is even more important than previously that a robust price control is achieved.

The Association welcomes Ofgem's development of an approach to capital investment that anticipates a variety of outcomes. We believe this is necessary to cope with the variety of scenarios that are currently credible for future pattern of generation.

We are concerned that, at what is quite a late stage in the process of negotiation of the Price Review, there are still a number of areas in which we await sight of the detailed proposals. For the process to meaningfully involve generators, we must not be faced with a rush immediately prior to Christmas.

DETAILED COMMENTS

Chapter 7: General price control policy and cost assessment issues

7.1: Do you agree with our proposed incentives for efficient capital expenditure, including a 25 per cent incentive rate?

The Association accepts that there is an asymmetric risk arising from the provision of not enough, as distinct from marginally too much network access. The value of 25% is set as an average of the current rates. We have no basis to dispute this approach for the future. Given that access and charging for the transmission network is set using a GB-wide methodology, it would seem sensible that the two Scottish TOs should have the same incentive as the E&W. We note that Ofgem have a smaller benchmarking sample for TOs than they did for distribution network operators. Is there no international benchmarking that could aid Ofgem here?

Ofgem repeatedly (Para 7.6 & 7.7) comment on the lack of output measures for transmission. This is then adduced as a reason why 25% is the value chosen. Again we would have thought that international research might provide help here. Additionally, Association members would be willing to engage in a discussion facilitated by Ofgem to develop such output measures. From a generator's perspective a number of issues would need to be considered: the speed of provision of new access, combined with its cost effectiveness, and the continuing provision of adequate volume, combined with its cost. We suggest that the licensees should have a time-bound licence obligation to engage in meaningful discussion with parties with a view to bringing forward such measures.

7.2: What do you think about our proposals to address significant capex under spend? In particular:

(1) What action should we take if this happens?

Given that we anticipate less easily forecastable investment requirements over the next five years and beyond, we would suggest that a review rather than just an automatic pre-determined adjustment should be available to Ofgem. The reporting process should signal the growth of under-investment and hence give the companies time for proposing corrective action or for Ofgem to indicate the likely consequence of continuing under-spend: automatic adjustment or review.

(2) At what level should we trigger this response?

Ofgem have suggested 20%, i.e. approximately one year's worth of expenditure as a trigger point. This seems reasonable, particularly as the companies will be reporting progress on a quarterly basis and hence underperformance should be well signalled.

(3) Should this response apply to load related and non load related capex?

Although non-load related capex is probably easier for Ofgem to measure, it is the result of load and non-load related expenditure that delivers the network

access for generators; the output of the process. Therefore we would suggest that the review should include both.

7.3: *Do you agree with our proposed approach for dealing with uncertain costs including future input price changes, specific cost uncertainties, and wider regulatory developments?*

The specific uncertainties that Ofgem considers in the consultation document are outside the companies' control, but could have significant impact. Therefore we accept that Ofgem's approach seems reasonable. With specific reference to the inter-tso scheme, we recommend that Ofgem try to signal as soon as possible how and in what timescale such adjustments will be brought in. There is a disjoint between the calendar year approach to this scheme and the normal TNUoS charging year.

7.4: *What do you think regarding the proposed regulatory treatment of NGG's use of affiliated LNG?*

The Association agrees that it would not be appropriate to fund via the price control longer term investment in LNG facilities when in the medium to long term there may be alternatives available to contracting with LNG to provide transmission support and operating margins.

However we are aware that commercialisation of these services has been considered previously with little progress achieved. Whilst a licence obligation on NGG to develop tenders for competitive provision of such services may encourage further progress it is by no means clear that there would be sufficient competition to deliver significantly lower costs.

Chapter 9: Adjustment mechanisms and incentives: electricity

9.1: *Do you agree with our proposal that it is appropriate for NGET to have a different form of revenue driver from SPTL and SHETL?*

It appears to make sense to split the NG system into zones for the purposes of revenue drivers. For the Scottish TOs the relatively smaller size precludes the need for such splitting.

9.2: *Do you agree with our proposed mechanism to deal with baseline and revenue driver sample risk?*

We accept that the wide spectrum of possible projects means that there will be a 'sample risk'. The current revised planning proposals under consultation in Scotland, may lead to some clarification of the extent of that risk.

9.4: *What are your views on the appropriate method of providing connections to the Scottish Islands?*

Given the current lack of clarity about how this area might develop, we accept that Ofgem needs to keep options open. It is conceivable that the OTEG work may develop to such a position that provision of links by alternative providers might become commercially feasible.

9.5: *What additional output measures do you think Ofgem should capture when considering system performance?*

System performance includes all of the activities currently under the general heading of SO Incentive. We hope that Ofgem is taking the advantage of this years' enhanced information provision by NG to inform future considerations of system performance incentives.

9.6: *Do you agree with our view that an Innovation Funding Incentive is appropriate?*

In principle the Association has no objection to such an incentive, but awaits the detail before we can provide any further comment.

Chapter 10: Adjustment mechanisms and incentives: gas

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

We broadly support the approach to capacity release obligations including a requirement to offer baseline capacity on the day. However it has only recently become apparent that NGG intends to apply the same principles at offtake as at entry. That being that capacity upto baseline will only be available during the first hour or so of the gas day. We believe that baseline capacity should be made available throughout the day at offtake. This is because there are a number of offtakes that only utilise NTS capacity as an alternative back up supply where their usual supply is direct from offshore. If such capacity is not made available these customers will have to cease operation, whereas at entry it may be possible to secure capacity from other users at that ASEP. However we recognise that the incentive to release non-obligated flat capacity should provide some comfort in this regard, we query whether it is appropriate to include within day baseline capacity after 0800 in this category.

The principles for substitution that enable re-allocation of unsold baseline capacity should provide for efficient allocation of capacity. However, much work remains to be done to establish the methodology and transparency of process to provide confidence to industry participants.

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

We agree that it is appropriate to revise the revenue drivers in the light of more up to date information. The 80% factor applied to the revenue drivers for Pembroke and Grain will encourage NGG to seek contracting solutions to the provision of capacity but it is not immediately obvious that these generators would wish to constrain their operations in that way. However it is upto NGG to challenge this if it is not acceptable to it.

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?

We agree that it is appropriate to set a default investment lead-time for both entry and exit and that any variation to the lead time should occur prior to the long term capacity allocation process to provide parties with more certainty over when capacity will actually be made available. We also agree that NGG should carry some planning risk as this is a key part of their business and that if all planning risk were to be removed then a lower rate of return should apply.

We do however have some concerns with the proposed permit system and how it could operate across a price control period, when we expect there to be a number of large new connections serving new CCGTs. There may also be issues relating to how it will work between price control periods.

Our concerns arise from the potential for different treatment and outcomes for new connections over time. So for instance if NGG used all its permits in the first application by a CCGT for incremental capacity, it would not have any left if it thought that the second application would also need an extended lead time. The outcome of this would be that the first CCGT would receive no compensation for having to wait longer for capacity whilst the second one would receive compensation at an administered rate. We are not convinced this is an equitable approach from a new connectee perspective.

In addition whilst we understand that it is conceptually tidy to allow NGG to earn additional permits by early delivery of capacity we consider this should only apply where that date has been agreed with the connecting party. Early delivery of capacity that is not required by the consumer is of little benefit.

Also we are unclear as to whether these arrangements would apply only to applications for incremental capacity via the processes that may be defined in the UNC or whether they would also apply to ARCAs that are agreed out side of this process. Given the lack of flexibility in NGG modification proposal 116 over start dates and commitment dates we would expect the vast majority of new connections or significant increases in capacity at existing connections by non-DN parties to be via the ARCA process. Clearly any lack of consistency may well lead to determinations for each connection.

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

We consider that such an incentive is an import feature of the potential enduring arrangements that contemplate separate flat and flexibility products. The baseline quantity proposed has been derived from complex calculations by NG based on numerous assumptions about daily flows and supply / demand scenarios. This process has not been open to scrutiny by industry parties but it is widely accepted that this is a conservative estimate of actual

capability. It is anticipated that on any day, when NGG can more accurately assess system capability, that it will in almost all circumstances be significantly higher than the baseline quantity. Therefore an incentive or other means of ensuring that this is released to market participants is required.

The proposed incentive allows NGG to retain 50% of the revenue from non-obligated flat and flex capacity upto a capped amount of £20Mp.a. The main concern that we have is that this mechanism may work for flat capacity that has a non-zero reserve price but we do not understand how this will work effectively for short term flexibility that is applied for via the OPN process and has a reserve price of zero. The price of flexibility will only rise above zero when flexibility is constrained and allocated by an auction process. Such constraints are expected to be infrequent events. It is therefore important that NGG is encouraged to release discretionary flexibility when the system is not constrained. We do not consider that this incentive structure will achieve that, we therefore encourage Ofgem to consider other approaches.

10.5: Do you agree with our view that an Innovation Funding Incentive is appropriate?

As we stated in our response to the July document we consider that a clear case for an innovation incentive has not been made. We therefore await further information before we can comment further.

10.6: What are your views on our proposals for transitional offtake incentives?

Please see comments under Appendix 7 below

Chapter 11: Sustainable development and the environment

11.1: Do you agree that the licensees should be incentivised to reduce leakage of SF6? Do you agree that the incentive should be set for 5 years?

Whilst Ofgem's consideration of the 'greenhouse gas' potential of SF6 is laudable, we consider that the proper place for consideration of non-CO2 greenhouse gases is in the context and framework of the UK Climate Change programme. Otherwise an inappropriate emphasis will be given to it compared with other greenhouse gases.

Appendix 7: Offtake revenue drivers and baselines for NGG NTS

A7.1 Do you agree with our updated proposals for the transitional period with respect to:

1) Baseline levels?

Consistent with our response to the July document, we support this approach

2) Revenue drivers?

Consistent with our response to the July document, we support this approach

3) NGG NTS incentives

In our response to the July document we considered that more information was required to form a view as to the appropriate target level for the CLNG incentive. Some information is provided in this document but we think there might be a lack of consistency. This is because in both the transitional and enduring arrangements NG has accepted that the NTS is not constrained except in the South West quadrant. Therefore we are unclear as to why there should be any requirement for CLNG in the South East such that the only logical option is option 3.

A7.2 Do you agree with our updated proposals for baselines in the enduring period with respect to: including the adjustments proposed?

The treatment of 'efficient over-building'

We have some sympathies with NG's concerns, clearly when it owned and operated the entire network it could take a longer term holistic approach to investment decisions to deliver efficiencies by perhaps laying larger pipes or avoiding having to dig up the same piece of land only a few years apart.

However the rigorous commercialisation of the NTS / DN interface and adoption of a pure user-commitment process may mean that these efficiencies could be lost. As this is the world in which we now operate then we consider the Ofgem approach to be reasonable even if it does not deliver the best outcome for consumers over time.

Baselines

We support the nodal approach to baselines set at the practical maximum physical level at offtake. The process with regard to setting baselines at entry is more complex and the approach seems to keep changing even at this relatively late stage in the process. Clearly this is mainly a debate between NG and Ofgem.

The treatment of interruptible sites in the south-west quadrant

The provision of baselines to sites in the south west is a consequence of the desire to treat all offtakes in the same manner and does not reflect the physical reality of the network. We do not consider it is necessary to treat all offtakes the same as there are clearly different categories of offtake with different requirements. However should this approach of all offtakes being treated the same be adopted then it must be applied in a consistent manner for all matters relating to offtake points into the future.

We note that a revenue allowance of £ 2.8M has now been established as this is NG's estimate of the CLNG costs to provide firm capacity. We are not in a position to comment on this value as no further information is provided. However it is not clear whether this forms part of the CLNG incentive proposals above or whether there is a risk of double counting?

However it would seem that this is a direct additional cost to customers since any firm capacity charges paid by these sites will form part of existing allowed

revenue and therefore not offset this additional revenue allowance. As such it is a direct cost of these proposals.

Revenue drivers

See comments under question 10.2 above

Investment related buy-back actions

We have some concerns over the introduction of the concept of permits at this late stage in the process, see comments under 10.3 above

The treatment of non-obligated capacity

See comments above under questions 10.4 these concerns will also apply to interruptible capacity if this has zero reserve price.