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1 March 2007

Dear Colleague,

Transmission Price Control Review: Statutory consultation on the licence modifications

Introduction

This letter accompanies the statutory consultation on the proposed modifications to electricity transmission licences pursuant to section 11 and section 11A of the Electricity Act 1989, which are necessary to implement the Transmission Price Control Review: Final Proposals published on 4 December 2006¹. It builds upon the previous consultation documents on the proposed licence changes published in November 2006² and January 2007³ and summarises the main changes from the draft licence text set out in January.

Purpose and structure of the licence modification

To give effect to the Transmission Price Control Review Final Proposals, it is necessary to amend some of the existing conditions of the licences, delete others and introduce new conditions. In addition, we have taken the opportunity to rationalise the licences, including making various housekeeping changes and amendments to enhance the clarity of the provisions of the licensees' obligations.

This document sets out the main changes that have been proposed to the licences of each of the transmission licensees in turn and sets out the main points to note. The structure of this document is as follows:

- Appendix A – Modification of The Special Conditions of National Grid Electricity Transmission plc (“NGET”)
- Appendix B – Modification of The Special Conditions of SP Transmission Limited (“SPTL”)
- Appendix C – Modification of The Special Conditions Of Scottish Hydro-Electric Transmission Limited (“SHETL”)

¹ Transmission Price Control Review: Final Proposals, decision document, ref: 206/06, December 2006.

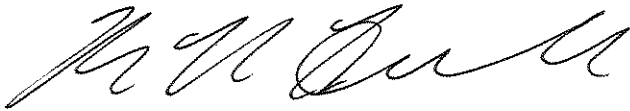
² Transmission Price Control Review: Draft licence modifications, consultation document, ref: 197/06, November 2006.

³ Transmission Price Control Review: Draft licence modifications (electricity) – second informal consultation, consultation document, ref: 10/07, January 2007.

- Appendix D – Modification of The Standard Conditions Of The Electricity Transmission Licences

Responding to this document

No comments are specifically sought in relation to this document. However, any representations or objections to the proposed licence modifications must be made in writing before **29 March 2007** to Colin Green, Office of Gas and Electricity Markets (Ofgem), 9 Millbank, London SW1P 3GE or via email to colin.green@ofgem.gov.uk

A handwritten signature in black ink, appearing to read 'R Hull', written in a cursive style.

Robert Hull
Director, Transmission

APPENDIX A – MODIFICATION OF THE SPECIAL CONDITIONS OF NATIONAL GRID ELECTRICITY TRANSMISSION

Introduction

NGET's licence obligations are derived from a combination of standard conditions for transmission licensees and special conditions specific to NGET. Obligations in respect of the revenue restriction are contained within the special conditions of NGET's electricity transmission licence. Other obligations including those in respect of the reporting requirements and financial ring-fencing are set out in the standard licence conditions. This appendix summarises the main changes in the special conditions.

There are two broad classes of change we are proposing to the special licence conditions to NGET's licence, namely those changes required to:

- Re-set the base (non-contingent) revenue allowances and main price control formula; and
- Set the rules for calculating a number of potential adjustments to revenues associated with logging up, revenue drivers and incentive mechanisms.

Proposed amendments

The TO and SO revenue restrictions for NGET are currently set out in special conditions AA5 to AA5H and schedules A and B of NGET's licence. For the purposes of giving effect to the revised revenue restriction, we intend to remove all references to the existing TO revenue restriction from these provisions (see part A of the section 11 notice issued under the Electricity Act 1989) and introduce the revised revenue restriction as part of a new suite of special conditions (special conditions D1 to D10 – see Annex 2 of the notice).

Main changes since the second informal consultation

Special Condition D1 - Definitions

We have made minor additions and amendments to the definitions applicable to the revenue restriction conditions. The main addition has been a definition of "logged up costs" for the purposes of the funding mechanism added to special condition D2.

Special Condition D2 – Restriction on Transmission Network Revenue

We have made several minor textual changes in the light of comments provided by the licensee. The main changes have been:

- to introduce a funding mechanism that will allow for the recovery of logged up costs that have been incurred within the price control period from 1 April 2012;
- to introduce an adjustment mechanism in respect of the mismatch of charges levied by the Scottish Transmission Owners, SHETL and SPTL, in respect of terminated connections and costs recovered by the NGET in its role as Great Britain System Operator ("GBSO"); and
- to incorporate terms that we previously proposed as part of special condition D4 within the main formula to reflect the context of the proposed adjustments.

No other substantive changes are proposed as part of this condition.

Special Condition D3 – Adjustment to the Transmission Network Revenue Restriction due to Transmission Investment for Renewable Generation

We have added a second part to this condition to incorporate the reporting arrangements that are currently set out within special condition AA5H. We had initially proposed that these requirements would form part of the proposed regulatory reporting pack, however in the light of comments received from the licensee we have recognised that the specific provision for reporting against the TIRG outputs is better located within the special condition.

In addition to the above, we have also made minor corrections to the algebra, particularly to the subscripts, to ensure that the calculations of the condition are undertaken correctly.

Special condition D4 – Pass through items

As discussed above, we have transferred several provisions previously proposed as part of this special condition to the revised special condition D2. In addition to these amendments, we have made the following substantive changes:

- we have provided additional text to clarify the process by which the Authority is able to direct the revenue adjustment term in respect of network rates; and
- we have incorporated an additional term that would, should proposed access reforms be implemented, allow for income that may be recovered under revised user commitment arrangements in respect of terminated connection schemes to be reflected within the revenue restriction.

Within the context of the second mechanism, we have proposed further drafting within special condition D9 (Capital Expenditure Incentive and safety net) that would allow the licensee to recover any capital shortfall where the income received does not fully cover the capital cost of the terminated scheme.

Special condition D5 – Incentive payments

We have made minor textual changes to the various parts of the incentive payments provision. The proposed amendments have been made to provide greater clarity of how each of the incentive mechanisms will operate during the price control period.

Special condition D6 – Adjustments to Transmission Network Revenue

The licensee has noted that the text set out in January did not reflect the modified thresholds that were introduced in December 2004 as part of the network reliability incentive. The policy intention has been to maintain the status quo position in respect of these provisions and consequently the revised text now accurately reflects the text of the current licence.

Special condition D7 – Allowance for security costs

The licensee has noted that powers of the Secretary of State to issue a direction in respect of the defined security period is wider than section 34(4)(b) captured in the existing licence. They recommended that the definition be widened to include all of section 34(4), which we have accepted.

Special condition D8 – Duration of the Transmission Network Revenue Restriction

As part of the re-structuring of special condition AA5E, the provisions relating to the duration of the transmission network revenue restriction have been moved from AA5E to the new special condition D8. The drafting has also been amended to provide greater clarity. We consider that this represents only a short term measure and we propose to consult upon aligning this provision with those of the other electricity licences as part of the next transmission price control review.

Special condition D9 – Capital expenditure incentive and safety net

The January consultation set out our initial drafting of the capital expenditure incentive that will provide for an adjustment to revenues in 2012/13. We have adopted a different formulation of the incentive to that set out in January in response to a number of issues raised by each of the licensees. The main changes are that:

- our formulation derives the revenue shortfall incurred by the licensee over the price control period, given the default assumption that efficiently incurred expenditure will enter the RAV in the year in which it is incurred;
- we have made several minor adjustments to the definitions of certain terms to ensure that the calculation of this shortfall is in the correct price base; and
- we have incorporated some changes in relation to the proposed revenue driver mechanisms.

In relation to the proposed safety net mechanism, we have only made minor amendments since January to clarify the scope of the mechanism.

Special condition D10 – Excluded Services

This largely reflects the draft text set out in January except for a minor amendment to provide for the appropriate reference to the reporting obligations.

House-keeping changes

We have undertaken a legal review of the current special conditions and identified the following redundant conditions:

- special condition C – Pooling and Settlement Agreement run-off;
- special condition I - Restriction on use of information deriving from the EnMo business;
- special condition J – NETA implementation; and
- special condition L – Change co-ordination for the Utilities Act 2000.

We propose to remove these conditions as part of this licence modification process.

APPENDIX B - MODIFICATION OF THE SPECIAL CONDITIONS OF SP TRANSMISSION LIMITED

SP Transmission's licence obligations are derived from a combination of standard conditions for transmission licensees and special conditions specific to SPTL. Obligations in respect of the revenue restriction are contained within the special conditions of SPTL's electricity transmission licence. Other obligations such as those in respect of the reporting requirements and financial ring-fencing are set out in the standard licence conditions. This appendix summarises the main changes in the special conditions.

There are two broad classes of change we are proposing to the special licence conditions to SPTL's licence, namely changes required to:

- Re-set the base (non-contingent) revenue allowances and main price control formula; and
- Set the rules for calculating a number of potential adjustments to revenues associated with logging up, revenue drivers and incentive mechanisms.

Proposed amendments

The TO revenue restriction for SPTL is currently set out in special condition J and supplemented by a number of other special conditions and schedules. For the purposes of giving effect to the revised revenue restriction, we propose to consolidate a number of conditions within the same suite of conditions (J1 to J11), which will be supplemented by schedules A and C. Those conditions that are being moved are set out in part A of the section 11 notice.

Main changes since the second informal consultation

Special Condition J1 – Restriction of transmission charges: Definitions

We have made minor additions and amendments to the definitions applicable to the revenue restriction conditions. The main addition has been a definition of "logged up costs" for the purposes of the funding mechanism added to special condition J2.

Special Condition J2 – Restriction of transmission charges: revenues from transmission owner services

We have made several minor textual changes in the light of comments provided by the licensee. The main change has been to introduce a funding mechanism that will allow for the recovery of logged up costs that have been incurred within the price control period from 1 April 2012.

No other substantive changes from January are being proposed as part of this condition.

Special Condition J3 – Restriction of transmission charges: Transmission investment for renewable generation

We have added a second part to this condition to incorporate the reporting arrangements that are currently set out within special condition Q. We had initially proposed that these requirements would form part of the proposed regulatory reporting pack, however in the light of comments provided by the licensee we have recognised that the specific provision for reporting against the TIRG outputs should be specified within the special conditions.

In addition to the above, we have also made minor corrections to the algebra, particularly to the subscripts, to ensure that the calculations of the condition are undertaken correctly.

Special condition J4 – Restriction of transmission charges: Allowed pass through items

We have provided additional text to clarify the process by which the Authority is able to direct that the revenue adjustment term in respect of network rates.

Special condition J5 – Restriction of transmission charges: total incentive revenue adjustment

The January information licence consultation set out our proposed detailed drafting of the proposed revenue driver mechanisms. We received several comments from the licensee in relation to the consistency of the proposed algebra with the intent of the final proposals. We have accepted many of the issues raised and propose revised drafting to more accurately reflect the TPCR final proposals.

We have also made minor textual changes to the various parts of the incentive payments provision. The purpose of these amendments to provide greater clarity of how each of the other incentive mechanisms will operate during the price control period.

Special condition J6 – Restriction of transmission charges: adjustments

We have made minor amendments to the cross references.

Special condition J7 – Restriction of transmission charges: Capital expenditure incentive and safety net

The January consultation set out our initial drafting of the capital expenditure incentive that will provide for an adjustment to revenues in 2012/13. We have adopted a different formulation of the incentive to that set out in January in response to a number of issues raised by each of the licensees. The main changes are that:

- our formulation derives the revenue shortfall incurred by the licensee over the price control period, given the default assumption that efficiently incurred expenditure will enter the RAV in the year in which it is incurred;
- we have made several minor adjustments to the definitions of certain terms to ensure that the calculation of this shortfall is in the correct price base; and
- we have incorporated some changes in relation to the proposed revenue driver mechanisms.

In relation to the proposed safety net mechanism, we have only made minor amendments since January to clarify the scope of the mechanism.

Special condition J8 – Provision of information to the system operator

We have incorporated this condition, which was previously special condition J1, and removed references to BETTA implementation costs.

Special condition J9 – Duration of the charge restriction provisions

We have identified an ambiguity within the drafting of the proposed special condition J9 in relation to the interpretation of paragraph 6 of the condition where the Competition Commission recommends amendments to the proposed modifications and has not expressly concluded that cessation of the charge restriction would not be in the public interest. We consider that the intent of such amendments to the proposed modifications would represent a conclusion that some form of restriction should continue to be in place. As a consequence, we have proposed an amendment to paragraph 6 of the condition to provide clarification in respect of this matter.

We have also proposed some minor amendments since the January consultation in respect of updated cross referencing.

Special condition J10 – Basis of transmission owner charges

The text in this condition has been introduced as special condition J10. It is consistent with the provisions of the special condition J2 that is presently in force, although the proposed text has been updated for accurate cross referencing.

Special condition J11 – Allowance for security costs

Another licensee has noted that power of the Secretary of State to issue a direction in respect of the defined security period is wider than section 34(4)(b) captured in the existing licence. They recommended that the definition be widened to include all of section 34(4), which we have accepted. This has been reflected within the proposed draft.

House-keeping changes

We have undertaken a legal review of the current special conditions and identified the following redundant condition:

- special condition H – Change co-ordination for the Utilities Act 2000.

We propose to remove this condition as part of this licence modification process.

APPENDIX C - MODIFICATION OF THE SPECIAL CONDITIONS OF SCOTTISH HYDRO-ELECTRIC TRANSMISSION LIMITED

Scottish Hydro-Electric Transmission's licence obligations are derived from a combination of standard conditions for transmission licensees and special conditions specific to SHETL. Obligations in respect of the revenue restriction are contained within the special conditions of SHETL's electricity transmission licence. Obligations in respect of the reporting requirements and financial ring-fence are set out in the standard licence conditions. This appendix summarises the main changes in the special conditions.

There are two broad classes of change we are proposing to the special licence conditions to SHETL's licence, namely changes required to:

- Re-set the base (non-contingent) revenue allowances and main price control formula; and
- Set the rules for calculating a number of potential adjustments to revenues associated with logging up, revenue drivers and incentive mechanisms.

Proposed amendments

The TO revenue restriction for SHETL is set out in special condition J and supplemented by a number of other special conditions and schedules. For the purposes of giving effect to the revised revenue restriction, we propose to consolidate a number of conditions within the same suite of conditions (J1 to J11), which will be supplemented by schedules A and C. Those conditions that are being moved are set out in part A of the section 11 notice.

Main changes since the second informal consultation

Special Condition J1 – Restriction of transmission charges: Definitions

We have made minor additions and amendments to the definitions applicable to the revenue restriction conditions. The main addition has been a definition of "logged up costs" for the purposes of the funding mechanism added to special condition J2.

Special Condition J2 – Restriction of transmission charges: revenues from transmission owner services

We have made several minor textual changes in the light of comments provided by the licensee. The main change has been to introduce a funding mechanism that will allow for the recovery of logged up costs that have been incurred within the price control period from 1 April 2012.

No other substantive changes from January are being proposed as part of this condition.

Special Condition J3 – Restriction of transmission charges: Transmission investment for renewable generation

We have added a second part to this condition to incorporate the reporting arrangements that are currently set out within special condition Q. We had initially proposed that these requirements would form part of the proposed regulatory reporting pack, however in the light of comments provided by the licensee we have recognised that the specific provision for reporting against the TIRG outputs should be specified within the special conditions.

In addition to the above, we have also made minor corrections to the algebra, particularly to the subscripts, to ensure that the calculations of the condition are undertaken correctly.

Special condition J4 – Restriction of transmission charges: Allowed pass through items

We have provided additional text to clarify the process by which the Authority is able to direct that the revenue adjustment term in respect of network rates.

Special condition J5 – Restriction of transmission charges: total incentive revenue adjustment

The January information licence consultation set out our proposed detailed drafting of the proposed revenue driver mechanisms. We received several comments from the licensee in relation to the consistency of the proposed algebra with the intent of the final proposals. We have accepted many of the issues raised and propose revised drafting to more accurately reflect the TPCR final proposals.

We have also made minor textual changes to the various parts of the incentive payments provision. The purpose of these amendments to provide greater clarity of how each of the other incentive mechanisms will operate during the price control period.

Special condition J6 – Restriction of transmission charges: adjustments

We have made minor amendments to the cross references.

Special condition J7 – Restriction of transmission charges: Capital expenditure incentive and safety net

The January consultation set out our initial drafting of the capital expenditure incentive that will provide for an adjustment to revenues in 2012/13. We have adopted a different formulation of the incentive to that set out in January in response to a number of issues raised by each of the licensees. The main changes are that:

- our formulation derives the revenue shortfall incurred by the licensee over the price control period, given the default assumption that efficiently incurred expenditure will enter the RAV in the year in which it is incurred;
- we have made several minor adjustments to the definitions of certain terms to ensure that the calculation of this shortfall is in the correct price base; and
- we have incorporated some changes in relation to the proposed revenue driver mechanisms.

In relation to the proposed safety net mechanism, we have only made minor amendments since January to clarify the scope of the mechanism.

Special condition J8 – Provision of information to the system operator

We have incorporated this condition, which was previously special condition J1, and removed references to BETTA implementation costs.

Special condition J9 – Duration of the charge restriction provisions

We have identified an ambiguity within the drafting of the proposed special condition J9 in relation to the interpretation of paragraph 6 of the condition where the Competition Commission recommends amendments to the proposed modifications and has not expressly concluded that cessation of the charge restriction would not be in the public interest. We consider that the intent of such amendments to the proposed modifications would represent a conclusion that some form of restriction should continue to be in place. As a consequence, we have proposed an amendment to paragraph 6 of the condition to provide clarification in respect of this matter.

We have also proposed some minor amendments since the January consultation in respect of updated cross referencing.

Special condition J10 – Basis of transmission owner charges

The text in this condition has been introduced as special condition J10. It is consistent with the provisions of the special condition J2 that is presently in force, although the proposed text has been updated for accurate cross referencing.

Special condition J11 – Allowance for security costs

Another licensee has noted that power of the Secretary of State to issue a direction in respect of the defined security period is wider than section 34(4)(b) captured in the existing licence. They recommended that the definition be widened to include all of section 34(4), which we have accepted. This has been reflected within the proposed draft.

House-keeping changes

We have undertaken a legal review of the current special conditions and identified the following redundant condition:

- special condition H – Change co-ordination for the Utilities Act 2000.

We propose to remove this condition as part of this licence modification process.

APPENDIX D - MODIFICATION OF THE STANDARD CONDITIONS OF THE ELECTRICITY TRANSMISSION LICENCES

In January 2007, we set out our proposed draft modifications to the standard conditions of the electricity transmission licences to give effect to certain aspects of the Transmission Price Control Review Final Proposals. In the light of the comments received from each of the licensees and other stakeholders, we have made a number of amendments. The main ones are outlined below:

B1 – Regulatory Accounts

The changes reflect drafting comments made by the licensees and are not materially different from the text proposed in the second consultation.

B9 – Indebtedness

Following discussions with various stakeholders, we have decided against implementing the amendments proposed in January. We had previously included definitions of “normal commercial terms” and “arms length basis.” However on reflection these definitions did not improve the clarity of interpretation.

B15 – Price Control Review Information

It remains our intention to implement the obligations in relation to the provision of Price Control Review Information from 1st April 2007 and we have amended paragraph 1 of the licence condition to clarify that the first year of the price control reporting rules will capture information relating to the financial year ending 2006/07. Some stakeholders expressed concern about the proposed provisions and we have therefore amended paragraphs 2(b) and 11(b) in order that licensees will not inadvertently find themselves in breach of the licence through no fault of their own. These paragraphs now refer to development of the rules by 15th May 2007 or such later date as the Authority may direct in order to avoid causing an unintended breach.

Another change to B15 relates to scenario modelling referred to in paragraph 3(c) of the January consultation. This paragraph has now been removed as it was decided that implementation of this through a common clause in B15 would have been difficult and potentially too onerous for licensees given their variance in size.

B16 – Revenue Reporting

Paragraph 2(i) of B16 has now been amended following concerns from licensees that the drafting was too wide. Consequently, we have amended this and now relate each of the templates required under paragraph 7 now relate to the specified information provided under paragraph 2.

Furthermore licensees also expressed concern that B16 potentially afforded no protection to them with regard to changes and amendments required under Part E. In response to this we have introduced the requirement for consent of the licensee to change the revenue reporting Regulatory Instructions and Guidance with the proviso that the licensee may not unreasonably withhold such consent.

B17 – Output Measures

In addition to minor textual changes to various parts of this condition to improve clarity, we have added a new paragraph 9 to set out more clearly the process of the Authority disapproving the network output measures methodology as proposed by a licensee. We have deleted Part E of this condition because the linkage between the failure to

implement an approved network measures methodology and switching to a penalties only regime for reliability incentives is set out in the relevant special conditions.

