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Dear Interested Parties

The Inter-TSO Compensation scheme for 2008 and 2009

On 15 November 2007 Ofgem granted conditional acceptance for National Grid Electricity Transmission plc ("NGET")[1] to participate in the voluntary Inter-Transmission System Operator Compensation ("ITC") scheme for calendar years 2008 and 2009 ("the 2008/9 scheme") and for it to seek recovery of the direct costs of Great Britain's ("GB's") participation in the 2008/9 scheme within the GB tariff mechanisms.

The potential costs of NGET, on behalf of GB, participating in an ITC scheme is provided for by the inclusion of a term to cater for the pass-through of ITC costs in the current revenue restriction.

This letter confirms our intention:

- To allow NGET to recover the direct costs arising from the participation of NGET in the 2008/9 scheme via the ITC_t term of its Special Condition D4; and
- To publish a direction fixing the value of the ITC_t term only once the Authority has approved NGET's charging methodology modification detailing the recovery method of associated direct costs within the GB tariff mechanisms.

The purpose of this letter is to explain the process by which we propose this should be done, and to seek industry views on the level of costs that NGET should be allowed to recover via the ITC_t term. The letter also sets out our current minded-to proposal not to make specific additional allowance for the inclusion of internal costs that would be incurred by NGET implementing the 2008/09 scheme to be treated as pass-through and recovered via the ITC_t term.

Background

History and legal basis of the ITC scheme

An annual voluntary ITC scheme has operated since 2002 and has been renewed each calendar year. A legal basis for a mandatory ITC mechanism took force from 1 July 2004 with the adoption of EC Regulation 1228/2003[2]. However, no ITC Guidelines have yet been

[1] NGET is the owner of the high-voltage transmission network in England and Wales and the system operator of Great Britain's high-voltage national transmission networks.
[2] Regulation (EC) No 1228/2003 of the European Parliament and of the Council of 26 June 2003 on conditions for access to the network for cross-border exchanges in electricity.

submitted to the Comitology[3] process for approval, as such any ITC scheme in operation remains voluntary.

The association of European Transmission System Operator ("ETSO")[4] has developed the 2008/9 scheme for the two calendar years 2008 and 2009. The terms of the circulated agreement contained a clause with the effect that if one or more TSO did not receive the support of their national regulator for their participation in the 2008/9 scheme, then the scheme would become null and void for all signatories. We understand that only with full participation could ETSO and the EC be confident of progressing mandatory ITC Guidelines within the two year timescale (i.e. for implementation from 1 January 2010).

On 15 November 2007 Ofgem granted conditional acceptance for NGET to participate in the 2008/9 scheme and for it to seek recovery of associated costs within the GB transmission tariff mechanisms. Further detail on the history and legal basis of the ITC scheme, and an explanation of the agreed 2008/9 scheme, is set out in an appendix to this letter.

Cost recovery

As part of the recent review process setting out transmission price control for the five-year period from 1 April 2008 to 31 March 2013, we created a term in the revenue calculation for NGET that would provide for the pass-through of costs relating to participation in any future ITC scheme and to allow NGET to seek recovery of such costs through the GB tariff mechanisms. The term can be found in Special Condition D4 'Pass Through Items' of NGET's electricity transmission licence and is defined as ITC_t. The value of ITC_t was set at zero until determined otherwise by the Authority.

The means by which allowed revenue is recovered from GB customers is determined by NGET's charging methodologies. Ofgem's decision on 15 November 2007 to allow NGET to seek recovery of associated costs within the GB transmission tariff mechanisms is conditional on NGET developing appropriate charging methodology modification to do so. We expect NGET to carry out the consultation on this modification shortly.

This letter sets out the expected level of the direct external costs on GB due to the participation in the 2008/9 scheme as well as the internal costs to be incurred by NGET in implementing this scheme. We welcome views on these cost elements generally and, in particular, the level of NGET's internal costs. After considering responses to this letter and subject to NGET developing appropriate charging methodology modifications, we expect to issue a letter in late summer 2008 to NGET setting the value of the term ITC_t under Special Condition D4 of the transmission licence.

Level of 2008/9 scheme cost

The 2008/9 scheme creates a central revenue fund from which TSOs who host significant network transits[5] can be reimbursed for the costs incurred by other TSOs within whose network originates causes of those transits. The central revenue fund is derived from the net flows across a country's electricity transmission network.

There are two main components of the net contribution charge: an infrastructure asset cost element to compensate for the extent to which the network has been used to host transit flows and a transmission losses element to reflect the assumption that cross-border flows contribute to the total network losses. The 2008/9 ITC infrastructure component is based on the infrastructure assets used to host cross-border flows and the level of cross-border flows caused and/or hosted by a country, and has been negotiated and fixed (ex-ante) for the duration of the agreement. The losses component will be based on real flows using a With or

[3] The procedure known as "Comitology" stipulates that the EC may only adopt or amend Guidelines following approval by a Committee of Member State representatives.
[4] ETSO is an international association of 32 associated member states and 35 independent TSO's.
[5] Transit is defined by ETSO as the hourly minimum of export and import for an ITC party, where export and import are the sums of physical flows on all exporting lines and all importing lines respectively.

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Without Transit ("WWT") method, hence has only been estimated ex-ante and will be subject to ex-post adjustment. Further detail on the calculation of each is set out in an appendix to this letter.

ETSO has calculated that GB's net contribution is €9.357 million per annum for the two year duration of the 2008/9 scheme.

NGET notes that this figure would be subject to an ex-post adjustment to account for losses on actual recorded flows and to cater for variance in contribution from perimeter counties[6], but expects this adjustment to be small, between 1% (approximately €100k) and 3% (approximately €300k) per annum based on predicable variances in transit flows across Europe and between Europe and perimeter countries.

In light of the above expectations on the limited forecast volatility of the ex-post adjustment for losses, NGET is seeking pass through of €9.357 million per annum for the two year duration of the 2008/9 scheme plus a further pass-through of the eventual adjustment ex-post.

Additional internal costs and cost recovery issues

In addition to the contribution to the 2008/9 scheme, NGET indicated additional internal costs that it would incur specifically for the implementation of the 2008/9 scheme. It also identified issues relating to exchange rate fluctuation and timing of the cost recovery.

Administration costs

NGET has indicated that its participation in the 2008/9 scheme and any enduring mandatory mechanism has implications for its internal processes and related Information Systems ("IS") required to facilitate this. These issues relate to:

- resources to accommodate the additional processes that need to be incorporated within NGET's routine operations relating to the process for calculating the ex-post losses element of compensation; and
- development of an Information System ("IS") required to facilitate efficient, auditable and robust participation in the2008/9 scheme and any enduring scheme.

NGET has estimated the total resource required to operate the additional internal processes for the 2008/9 scheme as between 0.5 and 1.0 Full Time Employee ("FTE"), generally rated to the level of professional engineer. NGET estimates these resource costs to be in the range of £25k - £60k for 2008/9, with a suggested annual resource breakdown of £60k for 2008 (1 FTE) and £25k for 2009 (0.5 FTE).

NGET also estimates the one-off resource required to develop and set-up the internal processes and agree the interface and data exchange processes with other TSOs and the ETSO data administrator to be 0.5 FTE. NGET estimates these one-off resource costs to be in the range of £20k - £30k.

NGET estimates the one-off IS costs to be £245k. This cost relates to the cost of IS resource to design the IS solution, but it does not include the set-up or running resource costs detailed above to assist in specification, testing and operation of internal processes.

Exchange rate proposal

The ITC scheme requires TSOs to pay into the central fund in Euros whereas NGET will pass through the costs incurred by the scheme in GBP. NGET notes that participation in the 2008/9 scheme will introduce a small reconciliation risk due to exchange rate fluctuations that may affect the accuracy of cost recovery under the revenue condition. NGET believes that this will

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[6] The upper range reflects a scenario that perimeter countries, for example Russia, export far less to the EC area than currently predicted.

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require an exchange rate mechanism to be applied to ensure accurate cost recovery within the TNUoS charging mechanism.

Timing of NGET's charges

The first year of the 2008/9 scheme became operational on 1 January 2008 and will end on 31 December 2008. This means that the period covered under the scheme is not synchronous with the financial year (1 April – 31 March) over which NGET's GB tariff mechanisms operate.

NGET has stated their intention to progress a charging methodology modification to recover the costs resulting from membership of the 2008/9 scheme in the calendar years 2008 and 2009 by TNUoS charges for the charging year 2009/10 and 2010/11 respectively.

Ofgem's initial views

Additional internal costs

NGET is seeking recovery of additional internal costs incurred by NGET implementing the 2008/09 scheme and for these costs to be treated as pass-through and recovered via the ITC_t term.

As noted above, the potential membership of GB in an ITC scheme on a voluntary or mandatory basis was provided for by the inclusion of the licence term ITC_t to cater for the pass-through of any future ITC scheme costs in the current revenue restriction. This term was subject to extensive consultation by Ofgem as part of the last transmission price control review. The treatment of costs resulting from wider regulatory developments, to include participation in a future ITC scheme, was specifically considered as part of this review process. The proposals themselves were informed by responses from industry, including NGET. No reference was made by any respondent to the level or treatment of additional internal costs incurred by implementing an ITC scheme. Furthermore, no approach was made to include an additional revenue allowance to NGET by way of an addition to the proposed licence pass-through term reflecting additional internal costs. As a result, Ofgem's Final Proposals for the transmission price control review[7] contained reference only to the recovery of direct costs incurred by NGET reflecting the extent to which GB would make a net contribution under any such scheme.

Moreover, as part of the transmission price control review process we established efficient System Operator internal costs for the 5 year price control period[8]. The potential for additional internal costs and the pass through of such costs was not raised by NGET and therefore did not feature explicitly as part of our final proposals.

We are currently minded for these additional internal costs to be absorbed by NGET as part of its general business costs and not form part of the contractual cost recovery discussed above. This is consistent with Ofgem's general high level principle in relation to introducing reopeners to the price control regime. We believe that allowing effective pass-through of all internal costs incurred as part of wider regulatory developments, especially those that were foreseeable, could potentially dilute the incentive properties of the price control regime. Therefore, we currently do not consider it appropriate to introduce a reopener for the internal costs that NGET would incur to implement the 2008/09 scheme.

We are currently minded not to make specific additional allowance for the inclusion of internal costs that would be incurred by NGET implementing the 2008/09 scheme to be treated as pass-through and recovered via the ITC_t term. We would welcome parties' views on this approach.

[7] "Transmission Price Control Review: Final Proposals", 4 December 2006, 206/06. Available from the Ofgem website. See paragraph 7.40.
[8] See "NGET SO incentives from 1 April 2007, February 2007". Available from the Ofgem website.

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Exchange rate proposals

We believe it is unnecessary to agree full pass-through of any reconciliation risk accruing from participation in the 2008/9 scheme. We are unconvinced that there is a significant revenue risk given the expected one year delay in cost recovery and our understanding that this level of cost will be the actual outturn level of cost to be recovered (or subject to only minor deviations due to the ex-post losses component). We believe that any potential risk/reward in relation to managing exchange rate fluctuations should therefore be absorbed by NGET as part of its general business costs and not form part of the contractual cost recovery discussed above.

We note however that the ITC scheme requires TSOs to pay into the central fund in Euros whereas NGET will pass through the costs incurred by the scheme in GBP. To facilitate the conversion of costs arising from the participation in the 2008/9 scheme in NGET's allowed revenue we are currently minded to agree a fixed date and time at which the exchange rate should be expressed and used as the basis for allowed revenue throughout the year. We intend to provide further detail on the approach to give effect to this cost conversion in the direction letter to NGET setting the value of the licence term ITC_t to be recovered under Special Condition D4. We believe that the existing licence drafting is sufficiently robust to allow for such a process. We would welcome parties' views on this approach.

Timing of NGET's TNUoS charges

We note NGET's intention to recover the costs incurred from 1 January 2008 until 31 March 2009 in charging year 2009/10 and costs incurred from 1 April until the end of the 2008/9 scheme (31 December 2009) in charging year 2010/11. It is currently envisaged that this will be done by the total costs incurred over each period being passed through to users (under the ITC_t term) in the charging year over which it will be recovered (i.e. 2009/10 and 2010/11).

Under the terms of the Electricity Transmission Licence Condition C4 5(a), NGET is required to give the Authority 150 days notice of any proposal to change the TNUoS charges (unless the Authority agrees to a shorter period). Practically, this requires NGET to inform the Authority of any changes before 1 November of each charging year.

NGET is also obliged to provide written notice of any revision to the Statement of Use of System Charges (containing the TNUoS tariffs) not less than 2 months from the beginning of a charging year (CUSC Section 3.20). This requires NGET to publish a statement of final tariffs (to apply from 1 April) by 31 January of each charging year.

In light of the above, we would expect NGET to develop a charging modification proposal to ensure the proper recovery of the costs of the 2008/9 scheme in the coming months for submission to the Authority for approval before late summer 2008. This will allow the Authority to make a decision before the 1 November deadline for the 150 day notice period for changes to TNUoS tariffs. We understand from NGET that the indicative tariffs contained in the Statement of Use of System Charges to be published in December 2008 will reflect the potential outcome of this decision, with final tariffs published before 31 January 2009. The above processes would also be used to provide notice of changes to TNUoS tariffs to recover the costs incurred within calendar year 2009 in charging year 2010/11.

If NGET does not deliver an approved charging mechanism for the recovery of associated 2008/9 scheme costs by 31 August 2008 then we expect NGET to assume the burden of these costs as part of its general business costs and not form part of the contractual cost recovery discussed above. Until such times as an approved charging methodology can be delivered we note that NGET retains the ability to approach Ofgem to seek to "roll over" recovery of these costs in the following year's revenue (similar to NGET's approach to costs resulting from membership of the 2008/9 scheme in the calendar year 2008).

Views invited

We welcome views and comments on any of the issues raised above, but specifically on:

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- our intention to allow NGET to recover the direct costs arising from the participation of NGET in the 2008/9 scheme via the ITC_t term of its Special Condition D4, to include the eventual ex-post adjustment for transmission losses;

- our intention to reject the recovery of internal costs that would be incurred by NGET implementing the 2008/09 scheme to be treated as pass-through and recovered via the ITC_t term.

- our intention to reject the adoption of an exchange rate mechanism for managing exchange rate fluctuations in the revenue condition.

We would like to hear the views of any interested parties regarding the issues raised in this letter. Written responses should be made by **Thursday 12 June 2008** to: Anthony Mungall, Office of Gas and Electricity Markets, 70 West Regent Street, Glasgow, G2 2QZ.

Alternatively, responses can be emailed to anthony.mungall@ofgem.gov.uk marked "**Response on ITC scheme**". If you wish to discuss any aspect of this document please contact Anthony Mungall, telephone 0141 331 6010.

Next steps

We expect NGET to bring forward a change proposal to ensure recovery of costs of the 2008/9 scheme are passed through to GB transmission users in an appropriate cost reflective manner consistent with their statutory and licence obligations. We also expect NGET to meet the conditions attached to our agreement to allow GB to join the voluntary 2008/9 scheme. Although this year's scheme appears to be more cost reflective than previous schemes, we still think the methodology could be improved and think that NGET has in important role to play in delivering further improvements to the ITC methodology in future. The two conditions are set out below.

- We expect NGET to keep the losses component of the ITC methodology under review and to complete a short audit report after the first year of the 2008/9 scheme (post 1 January 2009) to assure us that the charge to GB customers is reasonable and reflects a reasonable assessment of the costs of losses that transit flows to the UK impose on the wider European transmission system. In this report we request NGET to demonstrate progress of any learning on the application of WWT.

- We consider NGET to have an important role within ETSO to assist it in improving the cost reflectivity of the infrastructure component of the ITC methodology by bringing it more into line with the principles and approach that NGET uses in its own transmission charging methodology. Specifically, we think NG should seek to develop the methodology to use forward looking cost estimates rather than relying on historic investment costs and regulatory values. We expect NGET to demonstrate progress on this point within the two year duration of the 2008/9 scheme.

Yours faithfully,

Steve Smith
Managing Director, Networks

Appendix

History and legal basis of the ITC scheme

Early on in the process of introducing a single European market for electricity, regulators and the European Commission ("EC") focussed on the idea that a significant obstacle to cross-border trade was the need for participants wishing to trade across borders to pay two or more sets of transmission tariffs reflecting entry and exit charges, i.e. "pancaking" of tariffs.

To eliminate pancaking, continental TSOs have been voluntarily compensating each other for hosting cross-border flows. An annual voluntary ITC scheme has operated since 2002 and has been renewed each calendar year. Prior to 1 January 2008, TSOs in the UK and the Republic of Ireland had never been members of the voluntary ITC scheme.

A legal basis for a mandatory ITC mechanism took force from 1 July 2004 with the adoption of EC Regulation 1228/2003 ("the Regulation") on conditions of access to the network for cross-border exchanges in electricity. The Regulation in particular allows the EC to set binding guidelines on ITC payments/receipts.

Attention during 2004 therefore turned to writing formal ITC Guidelines under the Regulation to express the mandatory ITC mechanism. These discussions were based on the 2004 voluntary scheme, but with a revision to reflect the Regulation's requirement that costs are based on Long Run Average Incremental Costs ("LRAIC").

Between 2004 and 2006, difficulties with obtaining and evaluating real network flow data considerably delayed the development of an agreed methodology to measure and compensate cross-border flow costs in a manner consistent with the Regulation's LRAIC requirements. The result being that by late 2006 no ITC Guidelines had been submitted to the EC's Comitology process. For these reasons, the European Regulators Group for Electricity and Gas ("ERGEG") – the working group responsible for the development of ITC Guidelines among European regulators – did not submit formal advice to the EC. The impact of this delay was that the EC had no legal basis for a mandatory ITC scheme to be established from 1 January 2007 with little prospect of a mandatory arrangement being reached for implementation by 1 January 2008.

In the absence of agreement, ERGEG advised that until an agreed methodology is established it was their considered view that it was the responsibility of ETSO to reach agreement on the choice of method to be adopted in any interim period. ERGEG advised that ETSO should indicate as soon as possible its formal position on its preferred choice with respect to the methodology it intends to pursue with respect to both the interim period and for the longer terms, subject to the approval of the national regulators.

In light of ERGEG's advice, ETSO developed a proposal to apply for two calendar years (2008/9) that was again based on a voluntary approach[9]. To tackle the participation issue, ETSO's public position on the continuation of a voluntary arrangement was that the 2008/9 could only proceed with the inclusion of all its members. The terms of the circulated agreement contained a clause requiring all signatories to confirm the support of their national regulators for the inclusions of costs within the 2008/9 scheme within their national tariff mechanisms. The effect of this clause was that if one or more TSO did not receive the support of their national regulator for their participation in the 2008/9 scheme, then the scheme would become null and void for all signatories. The implication of this was that only with full participation could ETSO, ERGEG and the EC be confident of progressing mandatory ITC Guidelines within the two year timescale (i.e. for implementation from 2010).

[9] We understand that this was largely due to the EC view that it was impractical to take an ITC Guideline through Comitology while a full programme of negotiation on a new "third package" of European funding measures was taking place in 2007. The Comitolgy process for the enduring ITC scheme is expected to commence in summer 2008.

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All European TSOs signed the voluntary 2008/9 scheme on 12 October 2007 (NGET signed the agreement for GB). Ofgem granted conditional acceptance for the participation of NGET in the 2008/9 voluntary ITC scheme and for it to seek recovery of their reasonable costs incurred as a result of participation to GB customers through the national tariff mechanism. The voluntary ITC scheme became fully operational on 1 January 2008.

The agreed ITC scheme

The 2008/9 scheme is based on contributions from the cross border flows between countries participating in the 2008/9 ITC agreement and the sum of scheduled flows from "perimeter" countries. The ITC mechanism is a three step model. First, it calculates the compensation (cost claims) for each TSO whose system is used to host transit flows, and thus the total "fund" available to ITC parties. Second, the mechanism establishes the contribution (cost payments) to be paid by ITC entities to reflect their responsibility in inducing transit flows in other grids by participating ITC parties.[10] Finally, based on agreed principles for compensation and contribution, an ex-ante net financial result is calculated for each party to determine the level of payment to (or receipt from) the ITC fund based on the net flows across a country's network.

If the net contribution is anything other than zero, the country will pay in to the fund as it is deemed to be making use of other transmission systems to host transit flows. If the net contribution is zero, payment from the fund will be determined by the size of the deemed flows across that countries transmission system.

The calculation of compensation comprises of two main components: an infrastructure asset cost element to compensate for the extent to which the network has been used to host transit flows, and a transmission losses element to reflect the assumption that cross-border flows contribute to the total network losses according to the extent to which networks have been affected by cross border and transit flows.

The level of infrastructure compensation payment is based on two factors; the value of the infrastructure assets used to host cross-border flows and the level of cross-border flows between participating countries. The value of the infrastructure assets is based on regulated costs and the contribution level of each participating country is based on recorded actual electricity flows.

The value of the infrastructure assets used to host cross border flows is derived from ETSO's Allocation of Transit Flow (ATF) calculation method which identifies elements of each country's Horizontal transmission Network ("HN") that might potentially be used to host transit flows. A standardised procedure is adopted for defining the HN and has been used as the basis of previous voluntary ITC agreements. The ATF method models 100MW transits across the various possible transit routes available in each country. The resulting elements in any one country or network are combined with an estimate of associated asset costs in order to produce an estimate of HN costs for that country. Regulated asset bases were used as relevant estimates of the associated asset costs. The standard costs for assets were approved by the Council of European Energy Regulators (CEER).

The cost allocation for each country is completed by multiplying the HN cost for that country by the "transit key". That is, each country receives its HN costs multiplied by the transit key. The transit key is, for each country, the ration of transits across that country to transits plus consumption for that country, each expressed in GWh per year. Consumption is taken as the official annual value for the previous year (taken from annual reports ex-ante) and divided by 12. The 2008/9 ITC infrastructure component is therefore fixed (ex-ante) for the duration of the agreement, thereby providing stability and transparency for all participants.

[10] There is a second element of "contribution" which relates to contribution from perimeter country not party to the ITC agreement, but which has an electrical border to an ITC Party. Examples of perimeter countries include the Ukraine and Russia. The contribution from perimeter countries is calculated from a bi-directional perimeter fee equal to €1.4/MWh. This fee applies to gross imports and exports between participating and perimeter countries.

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The level of transmission losses compensation payment is also based on two factors; the value of transit losses and the level each participating country contributes to the total network losses.

The value of transmission losses costs are agreed among participating TSOs. For 2008/9, ITC parties have decided to consider the costs of transmission losses in the HN based on national prices. Generally TSOs would use their regulated settlement price for losses. However, given the different arrangements within the GB market relative to the rest of Europe NGET will submit an annual forecast forward energy price.

The level of transmission losses resulting from cross-border flows is calculated on a With or Without Transit ("WWT") method. This method calculates each TSO's transmission grid in a load flow situation 'with transits' based on actual network flows, and in a load flow situation 'without transits' where transits are removed and the hypothetical network flows needed to maintain system stability are calculated. The difference in network usage indicates the extent to which the network has been used to host transit flows and thus the extent to which, if at all, a TSO is entitled to compensation. The losses component is subject to ex-post adjustment to reflect deviations from the 2008/9 ex-ante scheduled import and exports. This will have repercussions on the net financial result for each country since the deviation shall be distributed pro-rata based on total net results.

Based on the above agreed principles of establishing the value of infrastructure and transmission losses compensation and the contribution from participating countries based on measurements performed during 2007 on cross-border flows and comparisons with previous ITC agreements, an ex-ante net financial result is calculated for each party to determine the level of payment to (or receipt from) the ITC fund based on the net flows across a country's network.

More information on the agreed ITC voluntary scheme for 2008/9 can be found on ETSO's website: http://www.etso-net.org/activities/cbt/e_default.asp

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