

National Grid Electricity Transmission and National Grid Gas License Amendment to include an Income Adjustment Term

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Overview:

We are seeking views from interested parties on how to fund expenditure by National Grid Electricity Transmission and National Grid Gas on improving security for critical national infrastructure in response to new security obligations imposed upon them by government. At the last price control a "logging up mechanism" was introduced but because the volume and costs of the work required by government has increased significantly we think it is appropriate to consider introducing an explicit funding mechanism.

The two National Grid businesses expect to spend around £250m - of which approximately £40m has already been spent - improving the robustness of critical national infrastructure on their networks. We have set out a range of options for the regulatory treatment and funding of this expenditure and would welcome views. This expenditure will result in an increase in transmission tariffs of around two percent.

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Context

The formal means of regulating a licensee's income is through the provisions of their licenses.

At the time of the last price control the forecast cost of capital expenditure on security works required by government was highly uncertain. The price control revenues were set without specific allowances for these. We agreed that these costs would be "logged up" and assessed and then funded through the next transmission price controls. National Grid would keep a record each year and at the next price control an allowance would be provided including a rate of return on all efficiently incurred expenditure from the date the expenditure was incurred.

Since the price controls were agreed the volume of work and cost has risen significantly. We think it is appropriate to implement an explicit funding mechanism for this expenditure and not to require NG's shareholders to fund this expenditure until the next price control. We are therefore proposing to introduce a revenue adjustment term into the relevant licences.

The proposed term already exists for the two Scottish transmission licensees; Scottish Power Transmission (SPT) and Scottish Hydro Electric Transmission (SHETL) but not for either National Grid Electricity Transmission (NGET) or National Grid Gas (NGG). It is proposed to provide these with an equivalent licence condition.

Associated Documents

- Link to existing special conditions in the Scottish Licenses March 2007
http://epr.ofgem.gov.uk/document_fetch.php?documentid=13661
- Link to the Transmission Price Control Review: Final Proposals December 2006
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses>
- Link to the Cost of Capital Study - Smithers & Co September 2006
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4/ConsultantsReports/Documents1/15576-smithers_co.pdf

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Summary

National Grid Electricity Transmission (NGET) is responsible for the electricity transmission system in England and Wales. National Grid Gas (NGG) is responsible for the National Transmission System for Gas throughout Great Britain.

The Government requires transmission licensees to undertake capital investment to improve the robustness of certain sites of critical national infrastructure at the behest of the government. National Grid has substantially more sites of this nature than either SPTL or SHETL both of whom are also undertaking this expenditure. SPTL and SHETL already have a revenue adjustment term in their licence which can be used to fund this expenditure.

When the Transmission Price Controls were settled in December 2006 the level of expenditure was uncertain and it was not included in the allowance determined at that time. For NGG and NGET we proposed using a "logging up" procedure because at that time the estimated level of expenditure was less than £100 million and this mechanism was considered appropriate for NG given the likely level of expenditure relative to their overall capital expenditure programme and price control allowances.

However after detailed work at the initial sites it became apparent that the forecast level of expenditure would be more than double the initial, albeit very uncertain, forecast.

For these reasons, we currently consider that NGET and NGG should have an explicit funding mechanism during this price control period to recover additional revenue to fund this expenditure. This document sets out our proposal to incorporate within National Grid's transmission licenses (for NGET and NGG) an income adjusting term equivalent to the term that already exists for the Scottish transmission licensees (SPT and SHETL). The proposed license amendment will enable NGG and NGET to recover revenues to fund this expenditure.

This consultation is not about the merits of the security expenditure. The Government has decided that the reduction in risk justifies this expenditure and neither Ofgem nor NG has any discretion over whether to make the investments. The Government plans to put these arrangements on a more formal statutory footing through the Counter Terrorism Bill and this will enable any related ongoing operational expenditure to be dealt with in future price controls.

The key questions for this consultation are whether we should introduce an explicit funding mechanism and the form and timing of any recovery mechanism. We are particularly interested in views on whether this security expenditure should attract a rate of return and if so, at what level that rate of return should be set at. One option would be to allow NG the same rate of return allowed under the transmission price control. Alternatively, we could allow them the risk free cost of debt. We have set out the arguments for and against the different approaches and would welcome views on what the appropriate regulatory treatment for this capital expenditure should be.

We estimate that if a revenue adjustment term is introduced, NGG and NGET will recover approximately £250 million. This could result in an increase in transmission allowed revenues and tariffs of the order of two percent.

1. Background

Chapter Summary

This chapter explains the circumstances that have led to consider the need for an income adjustment term in the licenses held by National Grid.

Question 1:

Do you consider the request by National Grid for an equivalent license term to the two Scottish transmission license holders to be reasonable?

Question 2:

Do you consider that licensees should have to wait for up to five years before receiving recompense on expenditure incurred at the behest of government?

Background

1.1. At the time of the fourth Transmission Price Control Review (TPCR4) the costs of improving security at key points of critical national infrastructure was not known with sufficient certainty to allow us to estimate an appropriate cost allowance. Since that time, a Memorandum of Understanding (MoU) has been agreed between the license holders, the government and the Authority covering the process for approving and vetting this expenditure.

1.2. The MOU incorporates a process where approval for site installation work will be undertaken in tranches (typically up to 8 sites) with audit checks and scrutiny. In addition independent auditors will check the efficiency and value for money of all the works undertaken by the licensees.

1.3. National Grid has requested that this expenditure is treated in a similar manner to the way equivalent expenditure incurred by the Scottish Licensees will be treated by the Authority. The licences of the Scottish companies contain an income adjustment term which with the agreement of the Authority enables audited expenditure to receive the commensurate revenue.

Timing

1.4. Without a license amendment National Grid would have to wait until the next price control period, in 2012, before receiving funding for this expenditure. Until then National Grid would have to fund this expenditure (.

The determination of relevant expenditure

1.5. National Grid have indicated they will provide to the Authority, by September each year, a set of Scheme completion reports for each site including independent operational and value for money audit results to substantiate the expenditure upon which a revenue adjustment term could be based.

2. Method of Treatment

Chapter Summary

This chapter explains the alternative treatments to recompense the license holders for the expenditure incurred.

Question 1:

Which of the "alternative treatments" do you consider the most appropriate?

Question 2:

Which of the "alternative rates of return" do you consider the most appropriate?

Alternative Treatments

2.1. There are a number of possible treatments for this expenditure. These are:

- "Logging Up", or in other words to continue with the current treatment of these costs;
- "Pass Through" of the costs, which would result in an immediate, commensurate increase in allowed revenue;
- "Income Adjustment" where the licensees revenue is increased by an appropriate amount which on capital expenditure includes a relevant rate of return; or
- "Direct Amendment" where the initial base revenue term determined at the last price control is amended to cover the forecast expenditure that had not been included when determining the allowance.

2.2. Under "Logging Up" all efficiently incurred expenditure is recorded and at the next price control is included in the regulated asset base. The adjustment to the value of regulated assets takes account of the delay in receiving income during the logging-up period.

2.3. This inclusion in the regulated asset base can be either at its gross value or an appropriate depreciated value to reflect the date of completion of each project. In the latter case this past depreciation is also allowed an appropriate rate of return to reflect the delay in receiving income. This element may then be paid as a single figure or spread in a present value neutral manner over the forthcoming price control period.

2.4. Under "Pass Through" the efficiently incurred expenditure for all completed projects is included in the revenue term for that year on an ex post basis (ie the previously assessed revenue figure for the year is increased by looking back during

the year and including the expenditure efficiently incurred on the completed projects). Consequently in the event of under recovery of revenue in that year interest at the appropriate rate of return is added for recovery in the following year.

2.5. Under "Income Adjustment" the efficiently incurred expenditure for all completed projects is included in the regulated asset base and the revenue in each year of this price control period is increased by a figure which reflects the return on the assets and the depreciation of these assets, as though this expenditure had been known when the price control was determined.

2.6. Under "Direct Amendment" the base revenue term determined at the price control is amended to a revised figure to reflect these forecast costs. This method differs from the revenue adjustment term because it uses forecast rather than actual costs.

Alternative Rates of Return

2.7. We consider that the rates of return determined in December 2006 during TPCR4 form a relevant backdrop to considerations about the appropriate return for this expenditure. The return that is earned on this expenditure is bounded by two values::

- The "weighted average cost of capital" adopted in TPCR4 (ie a real pre tax 6.25%)
- The "cost of debt" used in TPCR4 (ie a real 3.75%)

2.8. In the case of the "weighted average cost of capital", the return reflects both the return on equity and the return on debt; these are weighted using their respective proportions to the overall total. In the price control this was 40% equity at a then pre tax real rate of return of 10% and 60% debt on a pre tax and post tax real return of 3.75% making a weighted average real pre tax rate of return of 6.25%. It is this figure that would have been used had the level of expenditure been known with greater certainty in December 2006 when determining the allowance.

2.9. The reasons a single weighted cost of capital is used in price controls is because of the problem of deriving appropriate rates for each component of expenditure when the confidence limits for assessing each of these is likely to be wider than the differences in the rates between them. This was made clear in the Smithers report on deriving beta using kalman filters published in September 2006 and available from our website makes clear (a link to this report has been provided earlier in the section on associated documents).

2.10. The alternative approach would be to adopt only the "cost of debt". In the price control on a pre tax basis this was a real 3.75%. It is this figure that reflects the actual loss incurred by the licensee. However it does not reflect the opportunity loss incurred on the funds utilised should the monies have been deployed elsewhere.

The cost of debt

2.11. One of the main objectives in setting the cost of capital for this review is to facilitate the necessary capital formation (debt and/or equity) to enable the expected investment in the networks to take place.

2.12. The Smithers report concluded that the best long term estimate of the risk-free rate is 2.5 per cent, which is broadly consistent with the range of previous decisions taken by ourselves, other regulators, and the Competition Commission. The Smithers report also highlighted that we may need to apply a term premium to estimate the risk free yield accurately, although the evidence to support this is less clear.

2.13. The observable premium on utility debt is at historically low levels (within the range 98 to 130 basis points for A and BBB rated debt respectively). It remains unclear whether these levels may be expected to persist over the entire period of the price controls or revert to the long term average. In setting the cost of capital modelling assumption, we therefore used a real cost of debt figure above that implied by current market levels. Our analysis of long term average spreads supports a debt premium within the range 1.0 to 1.5 per cent.

2.14. In the light of these considerations, we concluded that an appropriate range for the pre and post-tax real cost of debt in the Final Proposals is 3.5 to 4.0 per cent. In the initial phases of the current "credit crunch" it rose towards this level but has since fallen.

The cost of equity

2.15. The transmission companies and investment community have argued that the cost of capital figure should be sufficient to enable companies to attract and retain equity funding. In determining the cost of equity assumption for our Final Proposals, we have had regard to traditional methods such as capital asset pricing model (CAPM) as well as wider market evidence, including the aggregate return on equity over time.

2.16. The Smithers study considered the long term aggregate market return on equity and concluded there was little evidence to justify a movement from the range 6.5 to 7.5 per cent considered during DPCR4. However, the report concludes that there is evidence that beta estimates are significantly lower than 1, which would support a lower equity return. As noted above, Smithers' central estimate, using a beta of 0.5, results in a range 4.5 to 6.25 per cent.

2.17. While beta estimates are presently lower than 1, they have varied significantly around this level since privatisation. It is therefore difficult to assess whether the recent estimates suggested by the Smithers report are representative of long term trends.

2.18. In view of the scale of the capital expenditure requirement, it is important that the assumed cost of equity is sufficient to enable companies to withstand unanticipated risks and to attract and retain equity funding. Given these considerations, we place greater weight on the range of total market returns than the components of CAPM. Nevertheless, in the light of Smithers' findings we considered it appropriate to adopt a real post tax figure of 7.0% a figure slightly lower than the assumption than was used at DPCR4 or GDPCR.

Gearing

2.19. Having considered the available evidence and the anticipated financing requirements of the companies, we concluded that an assumed gearing level of 60 per cent is appropriate. This is broadly consistent with the current gearing levels and the approach adopted at the last price control review.

2.20. This gearing assumption should not be interpreted as an endorsement of any particular capital structure. We believe that the companies and their financiers are best placed to decide on the most appropriate capital structure.

Factors to consider on the rate of return

2.21. This expenditure on critical national infrastructure is mandated by the government and we have indicated it will obtain a relevant revenue stream. The question is whether or not it is appropriate to unpick the average rate of return.

2.22. Amongst the reasons in favour of using a lower rate of return are:-

- there is no volume risk for National Grid because the number of sites has already been determined by the government,
- the risk of disallowance is reduced by the process of having value for money audits before each block of competitively tendered expenditure, thus effectively indicating that the tender prices have been efficiently determined.
- There is a reduction in risk to other assets that arises from the additional protection afforded by this type of expenditure. In particular the likelihood of damage that is not insurable by external markets.

2.23. However, there are also factors which suggest that the return earned on these assets should be greater than that earned by assets in the regulated asset base:-

- unlike schemes funded under the price control, the licensees have no opportunity to out-perform an ex-ante allowance because of the expectation that overall capital expenditure in the price control period will exceed the level used by the Authority when determining the allowances,

- licensees, in particular National Grid (which has most schemes) face increased price risk from the existence of value for money audits on each scheme together with an ex post efficiency review at TPCR5 at which point it will be possible to make explicit comparison between the costs incurred by each TO,
- finally, the introduction of an allowance for security costs which a lower allowed rate of return may be seen by the capital markets as a change in the regulatory regime which could be unsettling and lead to an increase in perceived risk. This is particularly the case if it has occurred unexpectedly without sufficient prior consultation.

2.24. We consider that there are arguments in favour of both the adoption of the weighted average cost of capital and the cost of debt. Consequently, we are seeking views on the relevant rate of return to use.

Income Adjustment Term

2.25. A copy of the form of license term which is in the Scottish licenses (for SHETL and SPT) is provided in Appendix 2.

3. Next Steps

Timing

3.1. There is a period of six weeks for interested parties to respond to this consultation.

3.2. Following consultation the Authority will determine the appropriate treatment. It is expected this will be in October 2008.

Other Factors

3.3. In reaching its decision the Authority will take into accounts the responses to this consultation and the following factors:

- The latest forecast level of expenditure being incurred and its materiality relative to the expected level of baseline capex expenditure when determining the allowance,
- The amount of additional operational expenditure forecast to arise as a consequence of this expenditure,
- Whether it is appropriate to amend the price control directly to provide additional revenue for this type of expenditure as used by the Civil Aviation Authority
- The chosen treatment for the Scottish licensees (SHETL and SPT), and
- Whether it is appropriate to amend the set a formulae of the form $RPI-X+K$ which has been used by the water regulator to provide for capital expenditure or if this form of change should await the outcome of the RPI@20 review.

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Appendices

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 19 September 2008 and should be sent to:

- Name: Duncan Innes
- Team: Transmission, Networks
- Address: Ofgem, 9 Millbank, London SW1P 3GE
- Telephone number: 0207 901 7108
- Email: duncan.innes@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to determine whether to make the proposed license amendment and the basis upon which the income adjustment term will be calculated. Any questions on this document should, in the first instance, be directed to:

- Name: Duncan Innes
- Team: Transmission, Networks
- Address: Ofgem, 9 Millbank, London SW1P 3GE
- Telephone number: 0207 901 7108
- Email: duncan.innes@ofgem.gov.uk

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CHAPTER: One**Question 1:**

Do you consider the request by National Grid for an equivalent license term to the two Scottish transmission license holders to be reasonable?

Question 2:

Do you consider that licensees should have to wait for up to five years before receiving recompense on expenditure incurred at the behest of government?

CHAPTER: Two**Question 1:**

Which of the "alternative treatments" do you consider the most appropriate?

Question 2:

Which of the "alternative rates of return" do you consider the most appropriate?

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Appendix 2 – Proposed License Amendment

Description

3.1. The purpose of this condition is to provide for revenue adjustments to reflect certain costs that can be passed through to consumers as part of allowed transmission owner revenue.

3.2. For the purposes of special condition D2 Restriction on Transmission Network Revenue PT is derived from a formulae, for example:

$TO = PR + TIRG + PT + IP + CxIncRA + IE + DIS + ER + LC + TS + IAT$ where

IAT means the income adjusting event revenue adjustment term, whether of a positive or negative value and shall be determined in accordance with the following paragraphs.

Definition of IAT

An income adjusting event in relevant year t may arise from any event or circumstance which is in the opinion of the Authority, an income adjusting event and is approved by it as such where the event or circumstance has for relevant year t increased or decreased costs by more than £1,000,000 (the STC threshold amount).

Where the licensee considers, and can provide the required supporting evidence that in respect of year t there have been costs that have been incurred or saved by an income adjusting event then the licensee shall give notice of this event to the Authority.

Illustrative License Code

(a) The Authority shall determine (after consultation with the licensee and such other persons as it considers desirable):

- (i) whether any or all of the costs and/or expenses given in a notice pursuant to this paragraph were caused or saved by an income adjusting event;
- (ii) whether the event or circumstance has increased or decreased the relevant costs and/or expenses by more than the STC threshold amount;
- (iii) if so, whether the amount of the proposed income adjustment ensures that the financial position and performance of the licensee are, insofar as is reasonably practicable, the same as if that income adjusting event had not taken place, and if not, what allowed income adjustment would secure that effect; and
- (iv) the periods, if any, over which the amounts should apply.

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(b) In relation to relevant year t, the allowed income adjustment (IAT) shall be:

- (i) the value determined by the Authority under the paragraph above; or
- (ii) if the Authority has not made a determination under the paragraph above within three months of the date on which notice of an income adjusting event was provided to the Authority, the amount of the allowed income adjustment proposed as a consequence of the event in the notice given to the Authority under this sub-paragraph (iii); or
- (iii) in all other cases zero, including situations where the Authority has not made a determination under paragraph (a) above within three months of the date on which notice of an income adjusting event was provided to the Authority and the Authority has, before the end of that three month period, informed the licensee that the Authority considers that the analysis or information provided in accordance with this paragraph is insufficient to enable the Authority to assess whether an income adjusting event has occurred and/or the amount of any allowed income adjustment.

(c) The Authority's decision in relation to any notice given under this paragraph shall be in writing, shall be copied to the licensee and shall be in the public domain.

(d) The Authority may revoke an approval of an income adjusting event and allowed income adjustment with the consent of the licensee, following consultation with the licensee and relevant parties. Revocation of any income adjusting event and allowed income adjustment shall be in writing, shall be copied to the licensee and shall be in the public domain.

Appendix 3 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.¹

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly².

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them³; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁴

¹ Entitled “Gas Supply” and “Electricity Supply” respectively.

² However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

³ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

⁴ The Authority may have regard to other descriptions of consumers.

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1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- Promote efficiency and economy on the part of those licensed⁵ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation⁶ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

⁵ Or persons authorised by exemptions to carry on any activity.

⁶ Council Regulation (EC) 1/2003

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Appendix 4 - Glossary

K

KALMAN filters - These are a recursive solution to the discrete-data linear filtering problem. The Kalman filter is a set of mathematical equations that provides an efficient computational (recursive) means to estimate the state of a process, in a way that minimizes the mean of the squared error. The filter is very powerful in several aspects because it supports estimations of past, present, and even future states, and it can do so even when the precise nature of the modelled system is unknown.

N

NGET - National Grid Electricity Transmission is owner of the electricity transmission license for England and Wales

NGG - National Grid Gas is owner of the gas transmission license for England and Wales

S

SHETL - Scottish Hydro Electric Transmission Limited is owner of the electricity transmission license for northern Scotland

SPT - Scottish Power Transmission is owner of the electricity license for southern Scotland

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Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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