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Dear Duncan

Ofgem Consultation 114/08: National Grid Electricity Transmission and National Grid Gas Licence Amendment to include an Income Adjustment Term

This letter sets out National Grid's view on how to fund the expenditure incurred by National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) on improving security for designated critical national infrastructure sites.

Securing our sites, which represent critical national infrastructure, is an integral part of National Grid's gas and electricity transmission business and we welcome Ofgem's consideration of the treatment of additional costs arising from new obligations with respect to these assets.

National Grid's response to Ofgem's specific questions contained within the consultation document is as follows:

Chapter 1 – Question 1: Do you consider the request by National Grid for an equivalent licence term to the two Scottish transmission licence holders to be reasonable?

As noted by Ofgem in the consultation document, the relevant works are not discretionary, revenues to fund these costs have not been included in the existing price controls and specific mechanisms to scrutinise the costs to ensure they are efficiently incurred have been established. On this basis, it is appropriate and reasonable to incorporate an income adjustment to the NGET and NGG price controls to fund these costs. Whereas alternative funding and cost recovery mechanisms could be formulated, the specific circumstances mean that establishing equivalent provisions to those already implemented in the two Scottish transmission licences would be acceptable and justifiable for the reasons discussed below.

Chapter 1 - Question 2: Do you consider that the licensees should have to wait for up to five years before receiving recompense on expenditure incurred at the behest of the government?

Now that the required works have been fully identified and their scope approved, the associated costs are being incurred by transmission companies. If Ofgem chooses to delay any cost-recovery until a future time, then transmission companies will incur larger financing obligations and future customers will incur costs which have been part of the service for existing customers. While it is for Ofgem to

determine what is in the best interest of consumers, present and future, the material nature of the costs together with the current financial uncertainties (which affects customers as well as transmission companies) suggests to us that it would be most appropriate to commence cost-recovery immediately rather than later.

Chapter 2 – Question 1: Which of the “alternative treatments” do you consider the most appropriate?

Of the suggested alternative treatments we note the following:

“Logging Up” means that transmission companies will finance these costs until revenues can be recovered from future customers. This imposes a significant additional financing task fully on transmission companies and requires future customers to incur costs which are associated with establishing the network for current customers.

“Pass-through” means that both capital and operating costs are immediately passed to current customers. This approach avoids imposing any additional financing obligations on transmission companies but requires present transmission customers to incur all costs (including those which may serve different future customers).

“Income Adjustment” means that the financing costs for the actual capital investments are passed to customers with near immediate effect. This means that financing costs are more correctly allocated to present and future customers. The transmission company will incur a financing obligation which depends on the regulatory depreciation period chosen by Ofgem but this will be a smaller financing task than under the logging up approach.

The “Direct Amendment” approach should have similar cost allocation properties between present and future customers as the “Income Adjustment” approach. Using forecast costs rather than out-turn costs places the risk of higher outturn with the transmission company. However, it also requires suitable forecasts (reflecting this price risk) to be agreed in addition to the scope, value-for-money and ex-post checks that will be used in the “Income Adjustment” approach. It is for consideration whether this additional work is warranted given the scrutiny of individual schemes that will be undertaken.

On the basis of the above, we suggest that the “Income Adjustment” approach is the most suitable as it provides an appropriate allocation between present and future customers while also recognising the specific scoping and approval process for these particular schemes.

An “Income Adjustment” condition provides suitable cover for both financial and operational costs however some adjustment to the Capex provisions (already contained within the transmission licences) may need to be made to avoid any unwanted additional exposure.

As highlighted in the consultation paper, National Grid will provide to the Authority a set of Scheme completion reports for each site to substantiate the expenditure by September each year. This would allow efficient time for the expenditure to be approved and then factored into the proposed tariff and associated industry tariff consultation. As the majority of these works will be concentrated during the summer months, it may be possible to include more completed Schemes if the Scheme closure deadline could be extended to October. This would better ensure that the revenue allowed was reflective of actual work completed and costs incurred.

Chapter 2 – Question 2: Which of the “alternative rates of return” do you consider the most appropriate?

For the reasons set out in the consultation document and the fact that these assets are an integral part of transmission activity we consider the weighted average cost of capital (WACC) the most appropriate rate of return. In particular, the transmission companies will be required to finance these schemes (even if only within year in the case of the full “pass through” approach) using the same sources of working capital as all other network activities. Even if it were theoretically possible to ring-fence and securitise the revenues for these schemes and so access debt only financing, this would not be achievable in practice. On this basis, these investments should be treated in the same way (and thereby receive the same WACC return) as all other network investments.

We look forward to seeing Ofgem’s final decision on the matter in due course but in the mean time should you wish to discuss any of the above comments please do not hesitate to contact me.

Yours sincerely
(by e-mail)

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