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Dear Hannah

Consultation on strategy for the next transmission price control – RIIO-T1 Overview Paper

Thank you for the opportunity to comment on Ofgem's open letter regarding the strategy for the Transmission Price Control. I can confirm that this response is not confidential and can be published on the Ofgem website.

The key points of our response are as follows:

- Central to the RIIO-T1 strategy must be the recognition that strategic investment is required to support the expected growth in low-carbon generation.
- We agree that Ofgem has correctly identified the key outputs for RIIO-T1 for both gas and electricity transmission. .The output categories appear reasonable and the initial secondary output categories seem appropriate.
- Any output measure should be technology neutral in nature and not favour any particular generation type or energy source.
- It should be recognised that there are numerous customers of transmission infrastructure, including end consumers. It is important that the interests of generators, shippers, suppliers and end consumers are considered when developing output measures.
- Funding arrangements for xoserve should be considered. One option might be to be split its funding out from RIIO-T1 and a separate price control, allowance and recovery mechanism set.

The RIIO-T1 framework has significant implications for our business as it has a direct impact on the costs that our generation business and customers face. The incentives developed under RIIO-T1 should aim to ensure that the optimally sized network is developed to ensure that the total costs to consumers of transmission infrastructure and constraints are minimised. It is recognised that RIIO-T1 is being progressed at the time of a changing regulatory regime. TransmiT might impact on the costs that individual market participants are exposed to; while the Energy Market Reform and Carbon Price Floor is likely to incentivise low carbon generation technologies to connect to the transmission networks. It is essential that these developments are complementary.

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Strategic Investment

We believe that strategic investment should be at the heart of the RIIO-T1 mechanisms, and specifically for electricity transmission. We note that there is likely to be a significant amount of new and replacement generation which will connect to the UK system within the next price control. There is therefore a risk of sub-optimal constraint costs, unless strategic investment is allowed and encouraged to address this. We believe that this will ultimately reduce costs to both existing and future customers by ensuring that the transmission capability is available where required.

Environmental Outputs

We believe that any output measure placed on the network owners should be technology neutral. The UK Government is determining policy objectives for the UK, including which technologies are supported and which are discouraged. It is the role of Ofgem to ensure that these policy objectives are implemented and the role of the network owners is to provide the required infrastructure to support the energy sources which need to connect to it. Any technology specific incentives run the risk that they interfere with Government policy, or create a further cross subsidy that might increase costs to consumers unnecessarily.

Competitive Tendering

One of the new tools available to Ofgem under the RIIO framework is the ability for them to require the network owners to conduct a tender when it is not clear if their procurement arrangements are fit for purpose. We believe that this tool might be extended to all procurement activities including the provision of IT services. This in itself should encourage the network owners to ensure that their procurement arrangements are robust and ensure that the costs to consumers are minimised.

I hope you find these comments useful, however please contact my colleague Stefan Leedham (**Stefan.leedham@edfenergy.com**, 020 3126 2312) if you wish to discuss this response further.

Yours sincerely

Rob Rome
Head of Transmission and Trading Arrangements
Corporate Policy and Regulation

Attachment

Consultation on strategy for the next transmission price control – RIIO-T1 Overview Paper

EDF Energy response to your questions

CHAPTER: One

Question 1: Do you have any comments on the proposed process and timetable for the review?
Overall the proposed process and timetable appear reasonable. However, we would note that this price control is key to ensuring that sufficient investment is delivered in electricity transmission to support low carbon generation. The RIIO-T1 mechanism should ensure that an appropriate process is followed, given the challenging timetable. This is particularly the case for this price control where the RIIO concept will be employed for the first time.

CHAPTER: Two

Question 1: Do respondents consider there are any interactions with other policy areas that have not been highlighted in this chapter?
We believe that Ofgem has identified the primary policy areas that have a direct impact on the RIIO arrangements. We also note that there will be impacts as a result of the Government's consultation on Energy Market reform.

Question 2: Do respondents consider that the transmission and gas distribution price control periods should remain aligned for future review periods?
At this stage it appears appropriate to align the transmission and gas distribution price control periods. However, we note that there is an increased regulatory burden from conducting price controls simultaneously and so there may be a value of splitting these in the future. We also note that the drivers and uncertainty regarding gas demand and distribution requirements are very different in the long term compared to electricity, which may warrant different periods going forward.

CHAPTER: Three

Question 1: Do you have any comments of the overall approach to stakeholder engagement?
Overall the approach to stakeholder engagement has been mixed by company. National Grid has been very proactive with stakeholder engagement, organising stakeholder questionnaires and events. However, it is likely to be prove challenging for many participants to manage all consultations and events and to keep track of what is being

progressed. We believe that in the future a more co-ordinated approach to stakeholder engagement may prove beneficial to all interested parties.

Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?
As previously mentioned, a more co-ordinated approach to stakeholder engagement amongst Transmission Companies may prove beneficial to all interested parties.

CHAPTER: Four

Question 1: Do you consider the proposed outputs and associated incentives, along with the other elements of the proposals, will ensure companies deliver value-for-money for consumers and play their role in delivering a sustainable energy sector?
At a high level the outputs and associated incentives appear appropriate, although we recognise that further work and development is required on the secondary output measures which will drive network behaviour. However, when developing the outputs there is also a need to recognise that the end consumer is not the only customer of the transmission companies. Whilst it is right that the end consumer is at the heart of these outputs there should be recognition that generators, shippers and suppliers are also customers of the transmission networks and their interests and requirements should also be considered when developing the output measures.

Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate?
The proposed outputs and incentive arrangements appear proportionate to the issues being addressed.

Question 3: Do you have any views on the proposed outputs or incentive mechanisms?
Yes

- Environmental Impact: We do not support any incentive that is targeted at a particular technology type or energy source. We believe that the role of Government is to set the policy which identifies which technologies and energy sources that should be developed by the market. The role of transmission companies is to connect these energy sources in the most cost effective manner and in doing so should not seek to differentiate between technology or energy source. The risk otherwise is that further cross subsidies are created which will increase costs to consumers and potentially interfere with Government objectives.

  Any incentive on direct network emissions should be in addition to those that the companies have already corporately committed to. In particular, we note that almost all energy companies have corporate sustainability commitments, which have been endorsed by their shareholders and investors. These commitments have already been funded by shareholders and so any incentive mechanism should only target environmental impacts in addition. This will ensure that costs to consumers are minimised.

- Customer Satisfaction: as previously noted we believe that a customer satisfaction matrix should be developed that incorporates all customers of the transmission networks.

- Connections: We believe that any output measure on connections should be technology neutral. However, we recognise that this is an appropriate output mechanism. On electricity we believe that the output measure should look to encourage the transmission owners to take a co-ordinated approach to the planning regime with generator developers, so that the associated transmission is considered with the generators application. This will help to ensure that connections are delivered in a timely manner and not delayed in the planning process.

  On gas we believe that the output should focus on encouraging the timely and efficient connections. UNC modifications on this are being developed to provide greater transparency and governance over the connection process, however, RIIO-T1 should also ensure that these connections are delivered on time and to budget.

- Reliability and availability: On electricity we support a secondary output measure on failures and faults, average circuit unreliability and system unavailability. We believe that this will encourage the development of a robust network that optimises constraint costs. For clarity we do not support a "gold plated" network where all constraint costs are removed, as this will result in excessive costs for consumers. In addition, we believe that any output should be supported by a transparency requirement so that the industry can monitor and track system reliability and availability.

  For gas we believe that further work is required on flexibility outputs before any incentive is set. While we recognise that the outlook for gas is uncertain, including supply sources, we believe that there is a need to differentiate between within day flexibility in profiles and supply flexibility across days. While there may be a value in incentivising the delivery of within day flexibility, at this stage we are not convinced that it is constrained or that National Grid's within day flexibility forecasts are robust. We are also unconvinced that supply flexibility needs incentivising through an output measure. In particular, we note that National Grid has received revenues for the baselines that they are required to deliver.

CHAPTER: Five

Question 1: Is our proposed approach to cost assessment appropriate?
In general Ofgem's proposed approach appears reasonable. However, we remain unconvinced that a fast track approach for this price control is appropriate. In particular, we note that electricity transmission is undergoing a step change as the electricity sector looks to de-carbonise and replacement generation comes on line. It is therefore imperative that the RIIO-T1 mechanism ensures that the appropriate mechanisms and funding are in place to deliver this investment. This warrants the full attention of the price control teams to reduce the risk of errors occurring in the fast track process.

Question 2: Do you have any views on our proposed process for proportionate treatment?
In general, we believe that Ofgem's proposed process for proportionate treatment appears reasonable. However, all business plans should be subject to scrutiny to ensure that what appears to be a good business plan is based on solid assumptions and modelling. In particular, we note that a business plan, or any model, is only as good as the inputs and assumptions into that model. Ofgem should therefore ensure that assumptions, common to all network owners, are consistent. This might include expected economic growth rates and the assumptions used on connection of CCGTs which need to be consistent across gas and electricity. Where differences occur we believe that this should warrant further analysis to identify whether the differences are justified.

Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Should any additional criteria be added?
The criteria identified by Ofgem appear appropriate. We also believe that there may be a value in having the business plans assessed by a third party to ensure that they appear reasonable and appropriate.

Question 4: Do you have any views on the proposed role for competition in third party delivery?
This should help to provide an incentive on the network companies to ensure that they have the most efficient and effective procurement strategies. We also note that this principle could be applied to all services, including provision of IT systems and services.

CHAPTER: Six

Question 1: Do you have any views on the uncertainty mechanisms identified?
We are concerned that the uncertainty mechanisms identified might only be targeted when network companies' costs are higher than expected or allowed. We believe that this should be widened to cover instances when costs are unexpectedly lower, or when there is a significant upside to that which was expected when the final formula is set. We note that in gas the most significant issue in the last price control was in fact significant

revenue being triggered for National Grid for a project that never materialised. It is therefore important to ensure that the uncertainty mechanism covers both upside and downside to ensure that customers do not pay more than is required.

Question 2: Are there any additional uncertainty mechanisms required that we have not identified?
None identified.

Question 3: Are there any mechanisms that we have included that are not necessary and, if so, why?
At this stage we are unconvinced that a revenue driver for National Grid gas on incremental capacity uncertainty is required. In particular we note that in the recent National Planning Statements, consulted on by Government they dismissed the idea of constraining infrastructure developments to particular areas or corridors. This was mainly driven by the fact that gas supplies are already constrained by geographic requirements and so new gas storage facilities are only likely to develop in existing fields or in salt caverns; whilst LNG importation is likely to be constrained to deep water harbours. We are therefore unconvinced that there is any significant uncertainty regarding the geographic locations of future energy supplies at this stage.

CHAPTER: Seven

Question 1: Do you have any views on the role of innovation in RIIO-TI?
We agree with Ofgem that the scope for innovation is less in transmission than in distribution, and less in gas than electricity. The proposed funding and arrangements therefore appear appropriate.

Question 2: Do you have any views on the time limited innovation stimulus?
This appears sensible.

CHAPTER: Eight

Question 1: Do you consider that the package of financial measures identified will enable required network expenditure to be effectively financed?
As a package we believe that the financial measures will enable the required network expenditure to be effectively financed. We note that to fund investments there are three sources of cash for network companies, namely, debt, allowed revenue and new equity release. We believe that the package of financial measures should ensure that they network owners are able to access all these sources.

Question 2: Do you have any views on our proposed approach to depreciation?
We understand that the use of a 20 year asset life for electricity depreciation was chosen to increase the cash flow from allowed revenue to network companies to fund an increased level of investment and expansion in the networks. Extending the depreciation

period will reduce the cash flow from allowed revenue and so encourage electricity transmission owners to access alternative sources for cash, such as debt and equity. We believe that this approach is appropriate and will encourage the network owners to access the least cost source of funding for their investment requirements. This will reduce costs to consumers.

Question 3: Do you have any views on our preferred approach to implement any transition arrangements over one price control period where possible?
We believe that the proposed approach appears reasonable.

Question 4: Do you have any views on our preferred approach to remunerating the cost of debt?
We support Ofgem's intention to index the cost of debt to investment grade bonds. We note that in the past the cost of debt has been set at a point in time depending on historical perceptions. However, as the debt markets are fluid this has resulted in network owners being winners (when cost of debt reduces) or losers (when it increases). These movements are outside of the networks control and so we believe that indexing to the markets will remove this risk. In addition we believe that this will remove the premium that has historically been applied to cover the risk of market movements.

Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent?
At a high level this appears appropriate, although we would question what Beta has been assumed for network owner equity? We note that in the past Ofgem has used a Beta of 1.0, although in the DPCR5 they moved to a Beta of 0.9 to reflect that network companies are lower risk than the market average. Research conducted by Ofcom suggested that the equity beta of energy utilities was between 0.64 for National Grid and 0.12 for Scottish and Southern Energy with Scottish Power having an equity beta of 0.44[1]. Given that these ratios will also cover the riskier sides of these businesses, then it is clear that an equity beta of 0.9 is comparatively high. Ofgem should consider calculating the cost of capital and equity based on an equity beta of 0.7 or less; it may be possible to employ independent experts to determine an appropriate equity beta for the network owners.

Question 6: Do you have any views on other elements of our financial proposals?
We have no further comments.

EDF Energy
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[1] See Ofcom presentation available at:
http://xfi.exeter.ac.uk/conferences/costofcapital/papers/stephen_gibson_exeter_conference_beta_lecture.pdf