Consumer Focus
Campaigning for a fair deal

1 June 2010
Bogdan Kowalewicz
Gas Transmission
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Dear Mr Kowalewicz,

Proposed disposal of part of NTS for Carbon Capture and Storage – Second consultation and initial impact assessment

Consumer Focus welcomes the opportunity to respond to this consultation. Our comments below relate specifically to the questions posed in chapter five of the consultation document (NGG's revised proposal).

Principles

Consumer Focus's overriding principle is that the risks that consumers are exposed to from the disposal of part of the National Transmission System (NTS) asset must be kept to a minimum. As such, NG Carbon should be allowed the potential to make gains from the disposal but also should bear the costs of potential losses, not consumers. This is particularly pertinent given that consumers will be part-paying for the carbon capture and storage (CCS) project already through government monies via the Department of Energy and Climate Change (DECC).

Buyback and OPEX

We agree with Ofgem that consumers should not be subject to either buyback or OPEX activity undertaken by NG Carbon as the company should be incentivised to run the commercial operation efficiently in an attempt to make a healthy return on the investment. We are pleased that these form part of National Grid Gas's (NGG) revised proposals.

Consumer Focus's preferred approach to valuation and revenue sharing

We would prefer the application of a modern equivalent asset valuation (MEAV) to part of the NTS asset to ensure that the 'true' market value of the asset is revealed. This should make available efficient price signals to all market participants for future investment. We believe that consumers should gain the benefits from the market value of this asset by a mixture of a reduction in the RAB and a reduction in transmission charges. This is because gas consumers have funded and borne the risk of the investment of this asset when NGG (or its predecessor)

Artillery House
11-19 Artillery Row
London SW1P 1RT

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

first developed it. Furthermore, we would expect that the assets, which will be fully or largely depreciated, will have to a great extent remunerated investors. Thus subsequent benefits should flow to consumers.

We would hope that other members of the CCS consortium for the Longannet project could be encouraged to bid for this element of the pilot project to help reveal the value of this part of the NTS asset. We are of the view that the possible delay of the DECC CCS trial does not represent a good reason to refrain from inviting possible participants to register an interest in the asset. The primary objective should be to ensure that consumers gain benefit from an asset which is priced to accurately reflect its market value. If the asset can be valued using the MEAV methodology, we think that NG Carbon should be subject to all the future incremental revenues and costs, in effect, no revenue sharing. This represents, to an extent, the generic option a) on page 32 of the consultation document. We consider this to be by far the most appropriate solution and Ofgem should be able to justify fully why they have been unable to proceed with this approach.

Consumer Focus's second best approach to valuation and revenue sharing

If the above is not possible, due to a lack of interest or competition for the asset in question, we agree with Ofgem that the appropriate asset value should be made based on the best estimate of the RAB value. The valuation must not be made under an historic cost accounting (HCA) book valuation as this would in all probability result in a lower valuation in comparison with one based on the best estimate of the RAB value. This should ensure that customers do not continue to pay for an asset which will be optimised by NG Carbon as an unregulated business. The use of a HCA valuation method is most appropriate where large CAPEX investment is required. However, the current situation does not suggest that this is the case.

The payments for an advance of anticipated CCS revenues of £10m from NG Carbon to NGG should be passed on almost in full to consumers (via NGG). NGG's share of this payment should be minimal as NG Carbon, as a subsidiary of National Grid, will be in a position to make a return on the re-use of the asset. Furthermore, this will compensate consumers for the likelihood that NG Carbon will receive an asset at less than the market value. This is because it will have been valued at a period when the asset is coming to the end of it asset life and will not have been calculated using MEAV which is intended to produce efficient market signals to encourage the efficient replacement of part of the asset.

<u>Re-openers or revenue sharing</u>

With regard to the use of revenue sharing from future CO_2 flows, we believe there are two options available to Ofgem.

1. If, as we prefer, NG Carbon is fully exposed to future incremental revenues and costs the risks for consumers of this investment will be minimised. However, there is a risk that

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consumers could lose out if the asset has been significantly undervalued which would be reflected in a low transfer price.

NGG envisages that the relevant sections of the NTS would need to be removed from natural gas service in Q2 2013. The next full gas transmission price control will start in 2013. Any price control settlement is likely to last for at least five years, although separately from this consultation Ofgem is considering whether it should adopt longer term settlements as part of its RPI-X@20 project. These timings create an extremely uncomfortable tension: that the genuine market value of these assets may become visible only after a highly speculative transfer price is locked in to NGG's RAB for a number of years.

We encourage Ofgem to consider how to mitigate consumers' exposure to any errors in the transfer price. One method to do this may be to make the Authority's consent contingent on explicit upfront agreement from NGG that it will allow for its RAB to be adjusted once evidence of the true market value of the transferred assets has been ascertained (either through the operation of Longannet itself, or from the experience of any other CCS projects that genuinely test the market).

2. However, if this is not possible[1] then some form of revenue sharing from future CO_2 flows represents a 'second best' alternative to the dangers of an undervalued transfer price. The weighting of any revenue sharing should look to maximise the benefits to consumers from an asset they have initially financed while at the same time incentivising NG Carbon to operate the asset in an efficient manner. As an initial starting point it is our view that consumers should receive a majority share of the revenue from the future operation of the asset. We believe this option should only be implemented if all other options have been exausted.

We hope you find these comments helpful. If you have any queries about any of the points we have raised in this letter please contact Cem Suleyman on 0207 799 7932 or cem.suleyman@consumerfocus.org.uk.

Yours faithfully,

Cem Suleyman

Cem Suleyman, Senior Policy Advocate, Energy team

[1] Perhaps because NG Carbon might operate as a 'unregulated' business and as such Ofgem will not have the legal power to initiate 'claw backs'.

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