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Our Reference NG/LD
Your Reference

Dear Hannah,

RPI-X@20: Longer price control periods

Further to your working paper and the discussions at the stakeholder workshop concerning the above, I hope this short summary of National Grid's views on this is helpful.

Need for a longer-term perspective

In order to facilitate delivery of a sustainable energy sector and deliver value for money to consumers, particularly given the present uncertainties relating to technology and policy, we agree that there are greater needs for network companies to:

- Give attention to the long-term implications of their (reinforcement and skills) decisions.
- Anticipate future customer needs.
- Understand potential future scenarios and required outputs.
- Innovate and experiment with new delivery approaches.
- Manage risk and uncertainty effectively.

The extent to which we think these might be achieved using longer price controls for our networks is discussed below.

Bringing the longer-term perspective to price controls

In gas distribution, the longer-term regulatory treatments for mains replacement (which have provided volume commitments well in excess of 8 years) have been important in reducing the costs of meeting that particular output.

In gas transmission, with 5 year rolling entry and exit incentives commencing upon delivery, there are already parts of the transmission price control which span up to 13 years (5 years rolling plus 42 months delivery allowance that might begin at the end of the current 5 year period).

In electricity transmission, where potential developments to access arrangements and longer-term constraint incentives are still being considered, nevertheless there has been an 11 year arrangement for TIRG (Transmission Investments for Renewable Generation) but also significant industry debate on longer-term scenarios, especially in the ENSG vision work. Our suggestions on how to regulate and incentivise the identified anticipatory investment would review the degree to which outputs have been successful 5 and perhaps 10 years after completion of construction.

Given these positions, it is unclear whether the 8 year control in the straw-man will add significantly to the incentives relevant to decisions on major network reinforcements.

The potential benefits of longer-term price controls in terms of better aligning company decisions concerning operating costs, replacement expenditure, skills, R&D, etc, with the interests of consumers will depend on whether the resulting allocation of risks between companies and consumers brings more value to consumers given the rewards/returns that can be agreed. At this stage there is no information in the RPI-X@20 work which indicates how the risk/reward balance might evolve for consumers or companies if controls were lengthened.

Particularly important in a longer control will be the use of appropriate output measures for asset stewardship otherwise the additional discretion (on the timing of actions) available in a longer price control may not be used in a manner aligned with consumer interests. While there has been significant work on developing improved asset health output measures since the current transmission price control was put in place, the mechanisms for relating revenues to such outputs have not yet been discussed.

In terms of exploring the balance of risk/reward, the nature of a mid-point review (including the rights to appeal, etc) are clearly also very important for companies and consumers.

Next steps

With respect to the areas where particular views were sought in the working paper:

1) The potential nature and scale of benefits of a longer price control period

While the straw-man approach may not significantly address the priority investment issues in transmission, there is merit in considering measures beyond those things already identified in the RPI-X@20 emerging thinking document. Given the size of electricity transmission reinforcements identified using scenarios that achieve government renewable and low carbon energy goals, and given the flexibility enhancements that may be required to gas transmission to maintain security of supply, it is particularly important to consider the treatment of anticipatory/facilitating investment to complement the existing incentives surrounding outputs that are subject to user commitment. The benefits of such a framework include:

- Facilitating sustainable energy goals by reducing network barriers of either delayed access or high congestion.

- Achieving a good trade-off between investments that might deliver economies of scale but might also have larger risks of being too big/too early when viewed in retrospect.

- Avoiding regulatory micro-management and the associated shift of risk management responsibility from network companies to Ofgem.

Ofgem's views and a wider debate on the anticipatory investment incentive suggestions we submitted before the RPI-X@20 project commenced would be valuable.

2) Whether the straw man sufficiently identifies the potential drawbacks of setting a longer-term price control

The key drawback, as identified in the working paper, is due to the greater variability of drivers and the potentially required responses which, as well as making forecasting more challenging, will also make the uncertainty mechanisms more important and therefore the task of reaching agreement on them more difficult. Inevitably the uncertainty mechanisms (revenue drivers, indexation, etc) will become more complex and less transparent.

The straw-man proposal of a mid-way correction brings an obvious risk that it will develop into a defacto review at 4 years (i.e. shorter than current controls). A resetting of outputs and the associated allowed revenues for the remainder of the control 'when necessary' means that it will be material when it does take place and thereby proportionately as important as the original setting of the price control.

3) The length of time between comprehensive price reviews

If there are enhanced mechanisms that incentivise both the response to user commitments and the correct anticipation/facilitation of desired outcomes, then undue delay in setting the necessary parameters will need to be avoided and they will need to be set for specific outputs as needs arise (for example, similar to the process for setting a UCA for new gas transmission entry point). However, at some point a comprehensive review will be needed to ensure consistency of parameters and their combined effect. The extent to which individual outputs can be considered in isolation or should be considered holistically depends on the extent to which they are narrowly focused or grant wider discretion.

4) The scope of any small scale mid-period review

If these are to be used, we think the scope should be as tight (i.e. pre-determined) and limited as possible.

5) How the approach might vary between sectors

In transmission there is a need to enhance transmission controls to address developing policy and technology needs for anticipatory investment. There is also a need to define how asset health/stewardship output measures will be used in the regulatory contract. These issues are different in the gas distribution area and, given the currently established output measures, the benefits of longer-term controls might be considered without the need to first develop definitions and measurements of the key outputs.

In summary, while National Grid supports measures that would better align our incentives with those of consumers, the extent to which longer-term price controls would do this depends on uncertainty mechanisms as yet undeveloped in transmission and a risk/reward balance not yet determined for the wider set of RPI-X@20 changes. The mid-point correction in the straw-man cannot substitute for quantification of these aspects.

Yours sincerely,

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CC
Paul Whittaker