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Dear David

Transmission Price Control 4 – Scope of the “Adapted Roll-over” (2012-13)

I am writing in response to the above consultation document and welcome the opportunity to set out our thoughts on Ofgem’s proposed scope of the Transmission Price Control 4 (TPCR4) roll-over.

We broadly support Ofgem’s proposed objectives of the roll-over as set out in Chapter 2 of the consultation. That is, it should be proportionate; only reflect recent developments in policy insofar as it is proportionate to do so (ensuring any major change should be deferred until TPCR5); not delay critical infrastructure investment; and, as far as practical, enable an efficient process to develop TPCR5.

However, we believe that there are two further objectives that Ofgem should pursue in delivering the adapted roll-over. That is, Ofgem should deliver the commitments of the TPCR4 Final Proposals, in particular for logged-up costs and for the capex incentives; and there should be a clear, achievable and integrated timetable. We address both in the relevant sections below.

Notwithstanding the above, the over-arching objective of this roll-over must be to maintain stability in the regulatory regime, recognising both the ongoing significant investment in the transmission system and the associated financing requirements. Against this background, we strongly believe that a partial review of the cost of capital (as proposed in the consultation document) would result in an imbalanced answer and, hence, be destabilising. Given that a full review of the cost of capital would be disproportionate for a one year review, we support a roll-over of the current cost of capital with changes only associated with any adjustments for businesses to finance their functions during the roll-over year.

Turning now to the Ofgem's proposed scope of the adapted roll-over.

Scope of the "adapted roll-over" – general approach

(i) Capex

We fully support Ofgem's proposal to progress, and manage separately, the work that will continue on the enhanced TO incentives to set allowances for 2011-12 and 2012-13. Following detailed consultation during 2008 and 2009, Ofgem has already set out its proposals in this respect and to change the approach at this time would, in our view, risk a delay in delivering key infrastructure investments for no tangible benefit.

For base capex, while we would have preferred a true-up of historic capex, we agree that there is an element of efficiency in deferring the full assessment of historic capex until the main TPCR5 review. Hence, we understand Ofgem's proposal to focus on forecast capex for 2012-13 with an investigation into historic capex only where it is necessary. In this regard, we welcome Ofgem's commitment to base allowances on the companies' forecasts of capex requirements.

However, we believe that, as far as possible, the businesses should be kept 'whole' to the effects of deferral, and therefore, the indicative opening RAV for 2012-13 should be determined on the basis of expenditure to date with any adjustments for efficiency "trued up" at TPCR5. As part of the 2012-13 opening position, we believe that Ofgem should take account of its TPCR4 Final Proposals commitment to adjust the 2012 revenue to reflect the companies' performances under the base capex incentive and, where applicable, the local infrastructure revenue driver. The "settlement" of both in 2012 has been specifically provided for in the existing text of the licence and should therefore be included within the scope of the adapted roll-over. To the extent that the final position cannot be determined until a full assessment of the historic expenditure has taken place, appropriate provision will need to be made to allow for a further final adjustment to be made in 2013.

(ii) Opex

Ofgem's preferred approach to set the opex allowance based on average costs incurred in the first three years of TPCR4 yet applying a company-specific efficiency factor (option three) seems an appropriate way forward. The key feature of this option that makes it acceptable to us is Ofgem's recognition that the proposed efficiency factor "would reflect an expectation of how opex may change during 2012/13". We interpret this as meaning that in setting opex allowances for the roll-over year Ofgem will take into account where the network has grown during the TPCR4 period and, hence, where there is ongoing upwards pressure on operating costs. To do otherwise would be unacceptable to us.

(iii) Transmission policy

We support Ofgem's view that it would be disproportionate to develop and implement new and detailed changes to policy for a one year roll-over. To that end, as indicated above, we concur with Ofgem's intention to advance proposals on the funding of critical investments under the enhanced TO incentives workstream separately and in parallel to the work on the TPCR4 roll-over. Similarly, we agree that the work on Transmission Access Review (TAR) should be progressed in parallel. However, in the event that there are implications for the roll-over year to facilitate the outcome and implementation of TAR we believe that they should be taken into account to ensure that the transmission companies are not financially disadvantaged and that the regime is implemented in full. Other policy areas that might impact on the roll-over include offshore transmission, specifically the treatment of interconnection costs.

As Ofgem has highlighted, a number of revenue drivers were introduced for TPCR4 including the local infrastructure revenue driver. To the extent that Ofgem believes that it is appropriate to extend the revenue driver for a further year, we agree that associated Unit Cost Allowances would need to be updated. However, we question whether the uncertainty that underpins the local revenue driver approach presents itself in a one year roll-over and, hence, whether a base capex allowance for local infrastructure might be more proportionate.

As for other incentives, we agree that "no new regulatory incentives should be introduced and that the existing targets should be simply rolled-forward with the exception of any adjustments to address areas where there has been significant misalignment between TPCR4 baselines and the outturn values".

We also agree that it is appropriate to simply extend the application of the existing network output measures methodology for the roll-over period. Developing additional output measures is part of the RPI-X@20 workstream and we remain of the view that these will be particularly difficult to establish in transmission if, for example, measures are to be based on asset utilisation.

(iv) Stakeholder engagement

We support Ofgem's proposal to continue the approach adopted under DPCR5 on stakeholder engagement and the engagement practices that include Ofgem-led workshops, challenge groups, bilateral meetings, and panels and working groups. However, in doing so, we believe that Ofgem will need to be proportionate in its approach particularly given that there is no intention to introduce anything "new" under the adapted roll-over and the number of other activities upon which Ofgem and the companies will be engaging with stakeholders (see our comments below on timetable).

We also note the existing charging forum run by National Grid and believe that these would be the appropriate bodies to consider the impact of the roll-over on transmission network use of system charges.

(v) Logged-up costs

Ofgem has not mentioned logged-up costs in this consultation. In order to deliver TPCR4 Final Proposals, we are firmly of the view that Ofgem should assess and make appropriate additional allowances for the allowed logged-up costs incurred during TPCR4 including costs associated with securing critical network infrastructure. To do otherwise would expose the companies for a further year of hitherto unfunded, yet justified, expenditure which would be inappropriate.

Scope of the "adapted roll-over" – financial issues

(i) Cost of capital

We do not agree with Ofgem's proposal to update the Weighted Average Cost of Capital (WACC) for changes in market assumptions with a high level review of all other inputs to the WACC calculations with further analysis and update only where change is justified. In our view, this represents an inappropriate partial review that would result in the 'wrong answer' and would allow Ofgem to 'cherry-pick' particular elements of the WACC calculation at its own discretion. Any proposal to change the WACC should only follow a full review and since this would appear disproportionate for a one-year roll-over, Ofgem should simply extend the current TPCR4 WACC for 2012-13.

It is important to remember that the cost of capital for electricity transmission companies is relative to a background of significant and ongoing investment. It is widely acknowledged that timely and efficient delivery of this investment is critical for ensuring security of supply and meeting renewable targets. We strongly believe that undertaking a partial review of WACC, that results in a value inconsistent with the companies' investment requirements even for one year, has the potential to cause a delay in that necessary investment. The need for stability in the roll-over year is a strong reason for retaining the TPCR4 WACC.

In addition, the necessity of this investment raises particular issues associated with financing in a competitive market for utility financing. Consequently, it is concerning that Ofgem's proposals in this consultation are around a partial review of WACC, but do not consider the wider financing duty.

The consultation document also describes Ofgem's intention to, separately, undertake a RORE analysis. Like the WACC, RORE analysis needs to be business-specific and derived from a full review of the financial "package" that takes into account transmission issues such as the requirements for financing large scale investment programmes and lower out-performance opportunities. If RORE analysis is to be undertaken, it should be on a comprehensive, transparent and business-specific basis in parallel with the detailed review of WACC.

However, as Ofgem describes in the consultation, a full review of WACC (and, by implication, RORE) would be disproportionate for a one-year roll-over. Hence, reviews of WACC and RORE should be preserved for TPCR5 for consideration alongside the outcome of the RPI-X@20 project. As stated above, in our view, Ofgem should simply extend the current TPCR4 WACC for 2012-13.

For the avoidance of doubt, we would not accept the cost of capital recently set for DPCR5, this was set in the specific context of the DPCR5 package as a whole and on Ofgem's RORE analysis of that package. It would not therefore be appropriate to try and replicate it in any other review.

(ii) Capitalisation and depreciation

We agree with Ofgem's minded to position to continue with the TPCR4 treatment of capitalisation and depreciation for the roll-over period. This would also mean that Ofgem would not consider a move to equalising incentives (as per DPCR5) for the roll-over year. These aspects of setting a price control are key to Ofgem's RPI-X@20 review and to make changes prior to the outcome of that review would be inappropriate. This approach will take some time to develop and model; the approach is particularly challenging in transmission (given, for example, the magnitude of capex to opex) and, hence, we would question whether such an approach is appropriate for transmission at all.

We note that SHETL's pre-vesting assets are fully depreciated in March 2012 and therefore the 'cliff-edge' policy agreed at TPCR4 will need to be implemented for the roll-over year. Furthermore, whilst retaining the existing capitalisation policy, Ofgem should be aware that our actual capitalisation rate will continue to increase due to the number of major projects being undertaken.

(iii) Tax

In principle, we support Ofgem's proposed approach for the treatment of tax for the roll-over. That is, to "review expected tax costs using appropriate capital allowances, current tax rates and the form of tax calculation used in DPCR5 (defer tax clawback)".

(iv) Pensions

In general, we welcome Ofgem's intention to apply the outcome of the pensions review (and principles established at DPCR5), as far as is possible, to the roll-over. We support the proposal to establish allowances for ongoing contributions and deficit repair based on the most recent actuarial valuation. In addition, we agree with the intention of establishing the regulatory fraction.

However, while we recognise the relative efficiency of delaying the pensions true-up until TPCR5 (particularly given that SHETL's next actuarial valuation is not due until March 2012), we believe that a commitment should be made to the scope of that true-up. This is a particular issue for SHETL which had no pension deficit allowance for the TPCR4 period but from 2009/10 has incurred deficit costs. It is our view that, at the roll-over, Ofgem should commit to making a one-off payment at TPCR5 as part of the true-up arrangements for the TPCR4 period.

A clear, achievable and integrated timetable

Ofgem has provided a high level, indicative timeline for the TPCR4 adapted roll-over which is welcome. However, we are concerned that there are a number of other streams of work that are being carried out in parallel such as the work on enhanced TO incentives, conclusions of the RPI-X@20 review, the start of TPCR5 and the start of GDPCR2. In addition, as Ofgem note in the consultation document, a number of other areas of policy work are likely to impact on the roll-over.

Given that most industry participants will have an interest in all of these areas of work either directly and/or as an interested stakeholder it will be vital to ensure that there is a clear, achievable and integrated timetable. Early co-ordination of the timetable of work over the next three years is critical to ensuring an efficient and successful outcome to the roll-over and TPCR5.

To conclude, we broadly support Ofgem's proposed scope for the roll-over and would hope that no "scope creep" will occur over coming months. In particular, SHETL is very much focused on efficient delivery of its existing large capital programme, and ongoing development work for future reinforcements, and the key objective of the roll-over must be to maintain stable conditions that support that work.

We hope that you will find these comments helpful and that you will feel able to take on board our suggestions where we are not fully aligned with Ofgem's 'minded to' position set out in this consultation.

If you would like to discuss any of the points we have made, please give me a call.

Yours sincerely

Rob McDonald
Director of Regulation