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Transmission Price Control 4 – Rollover (2012/13) Scope Decision and Consultation

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Target audience: Electricity and Gas Transmission Licensees, Electricity and Gas Distribution Licensees, Generators, Shippers, Suppliers, Customers and other interested parties.

Overview:

The current gas and electricity transmission price controls (TPCR4) expire on 31 March 2012. To enable the next price review to reflect fully the conclusions of the RPI-X@20 project, we have previously announced our decision to delay implementation of a full price control until 1st April 2013. We will implement a one-year rollover of the current price control to operate over the period 1st April 2012 to 31st March 2013. In March we published a consultation paper, "Scope of the "Adapted Roll-over" (2012/13)", outlining options and our 'minded to' approach to key rollover decisions.

Following this consultation we have reached our final decision on the scope of the rollover in a number of important areas, such as our approach to cost allowances, incentives and the cost of capital. There are other areas where we are seeking the views of respondents to inform our policy development.

Our decisions have been guided by the need to strike a balance between the application of sufficient regulatory scrutiny to fulfil the objectives of the rollover and the Authority's statutory duties, in particular our primary duty of protecting the interests of existing and future consumers, and the need for a review which is proportionate to the a one-year price control.

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Context

The Authority's principal objective in carrying out its functions under each of the Gas and Electricity Acts is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition. Regulation of network monopolies is necessary to protect the interests of consumers.

Regulation of Britain's energy networks encompasses a number of elements including the regulation of network businesses by means of price controls. The existing price controls employ incentive-based regulation often referred to as 'RPI-X regulation'. We are currently undertaking a fundamental review of the RPI-X approach under the auspices of our RPI-X@20 project. RPI-X@20 is looking to the future on behalf of existing and future consumers, to ensure that we have a regulatory framework that remains fit for purpose.

The energy industry faces considerable challenges and opportunities. These are primarily driven by the need to decarbonise Britain's energy sector, while maintaining a safe, secure and affordable system for existing and future consumers. Energy network companies have a key role to play – they provide the physical link between those producing energy, those selling energy services, and businesses and households who use energy.

The gas and electricity transmission networks have critical roles to play in delivering a low carbon economy, with around £40bn[1] of investment needed across transmission and distribution by 2020 to connect new sources of generation and accommodate continued increases in gas import capacity. Network companies will need to work actively with others in the industry and more widely to make the energy sector more sustainable while continuing to promote and facilitate competition.

As set out in our January 2010 RPI-X@20 Emerging Thinking consultation, we are seeking to build on the benefits of the existing framework to encourage energy network companies to play a fuller role in facilitating delivery of a sustainable energy sector and to deliver long-term value for money network services for existing and future consumers.

Given the importance and scale of the challenges facing transmission network companies, we want to implement the conclusions of RPI-X@20 in full at the next full price control review. We have therefore decided to delay implementation of TPCR5 by one year. The existing price control (TPCR4) will be rolled over by one year to cover the gap between the expiry of TPCR4 on 31 March 2012 and the implementation of TPCR5 on 1 April 2013. We think that the benefits to consumers of doing this outweigh the costs associated with conducting the rollover.

Where we have had cause to rollover price controls in the past. The price control for National Grid Electricity Transmission (NGET) was rolled over for one year from 1 April 2006 to 31 March 2007. The price controls for the two Scottish electricity

[1] the cost of upgrading the transmission and distribution networks (including offshore) to 2020. Modelled on a rapid economic recovery and a commitment to carbon abatement: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=73&refer=Markets/WhlMkts/Discovery

transmission companies were rolled over first for one year from 1 April 1999 to 31 March 2000 and then subsequently for two years from 1 April 2005 to 31 March 2007). We also used a similar approach for the gas distribution companies (the Gas Distribution Price Control Review (GDPCR1) was rolled over for one year from 1 April 2007 to 31 March 2008). This approach allowed us to align the periodic price control reviews and created a more even work load for Ofgem, the licensees and the industry.

Associated Documents

- Approach and timetable for the next Transmission Price Control Review (TPCR5): decision document (21/10)
  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/Documents1/TPCR5%20Approach%20and%20Timetable%20-%20Decision%20Document%20-%20FINAL.pdf
- Approach and timetable options for the next Transmission Price Control Review (TPCR 5): Notice of GEMA decision to delay the implementation of TPCR5 until 2013 and implement a one year adapted roll-over of TPCR4
  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/Documents1/FINAL%20-%20TPCR5%20draft%20letter%20of%20notice%20of%20Auth%20Dec%20(sig)%20(2).pdf
- Approach and timetable options for the next Transmission Price Control Review (TPCR5): Consultation (130/09)
  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/Documents1/Approach%20and%20timetable%20options%20for%20taking%20forward%20the%20next%20Transmission%20Price%20Control%20Review%20FINAL.pdf
- Transmission Price Control 4 – Scope of the "Adapted Roll-over" (2012-13): Consultation (34/10)
  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4%20roll-over/Documents1/TPCR4_Rollover_Scope_ConDoc_FINAL.pdf
- Regulating energy networks for the future: RPI-X@20 Emerging Thinking - January 2010 (05/10)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=emerging%20thinking.pdf&refer=Networks/rpix20/publications/CD
- Transmission Access Review – Enhanced Transmission Investment Incentives: Final Proposals (04/10)
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=204&refer=Networks/Trans/ElecTransPolicy/tar
- Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles
  http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=119&refer=Networks

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Summary

The existing transmission price controls, Transmission Price Control Review 4 (TPCR4), cover the five years from 1 April 2007 to 31 March 2012. Running alongside the price control process, our RPI-X@20 project is a detailed review of the future regulatory framework for electricity and gas transmission and distribution networks. To accommodate fully the conclusions of the RPI-X@20 project in the next transmission price controls, we announced on 21 December 2009 that we will delay implementation of TPCR5 until 1 April 2013, and will apply a one-year "adapted roll-over" (or "rollover") of TPCR4 from 1 April 2012 until 31 March 2013.

On 15 March 2010 we published a consultation on the scope of the rollover. The document outlined the objectives of the rollover process along with options for its scope. Informed by these objectives, the document it also set out our preliminary view of the scope of the rollover, or our proposed approach for each of the key policy areas. The consultation process has informed the decisions set out in this document. We also provide clarification in some areas in response to questions raised by stakeholders.

To ensure the regulatory burden imposed on all stakeholders is proportionate to a one-year price control and to avoid making decisions that may prove to be inconsistent with the principles developed through RPI-X@20review, the rollover should have the minimum scope consistent with our duties and the principle of better regulation. We will only deviate from this approach to reflect agreed policy developments, such as the recently concluded pensions review, the conclusions of which will be incorporated into the rollover.

This paper represents our final decision on the majority of scope items. The table on the following page summarises our decisions. However, there are a few policy areas where further analysis is required and in the case of which we are deferring our final decision. Accordingly, we would welcome views from respondents on the options for policy development in the following areas:

- Whether the current System Operator (SO) internal incentive scheme should be rolled over (taking into account the current external SO parameters) or whether an alternate approach be adopted.
- Whether we should continue to incentivise National Grid Gas to deliver capacity in a timely manner during the rollover year.
- Whether the operation of the incentive mechanism designed to encourage the reduction in Sulphur Hexaflouride (SF6) emissions (the "SF6 incentive") is likely to continue to represent value for money for the consumer.

We will defer a decision on whether it is appropriate to extend the electricity revenue drivers into the rollover period until we have received FBPQs from the TOs and fully understand their load-related capex plans for the rollover year[2]. In the meantime, we would welcome the views of stakeholders on this issue.

[2] We expect to continue use our TO incentives funding framework for major electricity transmission reinforcements and to use the prevailing cost of capital. We will consult separately on the details of the extension of the framework to 2012/13.

Table 1 Summary of rollover scope decisions

Aspect	Approach and scope for rollover
Capex	• A full assessment of historical capex will be deferred until TPCR5, adjustments will be made to the settlement and the opening RAV for any capex found to be inefficient or ineligible. • In the rollover, we will focus on forecast capex, investigating historical capex only where necessary to support scrutiny of forecast capex. • Capex incurred during TPCR4 (excluding logged up costs) will enter a provisional RAV on an indicative basis for the rollover. • "Logged up" costs will continue to be logged up, with an efficiency assessment and adjustments to the opening RAV taking place at TPCR5.
Opex	• Opex will be informed by actual expenditure in up to the first 4 years of TPCR4 (2007 to 2011) along with the TOs opex forecasts. • An adjustment will be made for efficiency on a TO specific basis.
Financial Issues	• *Allowed Return:* The allowed return / cost of capital will be reviewed. • *Tax*: We will update the capital allowance figures and the tax calculation in line with recent legislation. • *Pensions*: We will adopt the principles established during the recent review of pension costs initially set out in DPCR5 wherever possible. • *Capitalisation and depreciation*: we do not propose the change the treatment adopted in TPCR4. • *Calibration:* We will construct a financial model and conduct return on regulated equity (RoRE) analysis as per DPCR5.

1. Introduction and background

Chapter Summary

This chapter sets out the relevant background to transmission price controls. It describes the consultatative process that we have followed in reaching our scope decisions. It also discusses the relationship with other reviews such as RPI-X@20 and the recently concluded pensions review.

Price controls

1.1. Transmission price controls apply to the four electricity and gas transmission companies which own Britain's electricity and gas transmission networks. These are:

- National Grid Electricity Transmission Limited (NGET);
- National Grid Gas Limited (NGG);
- SP Transmission Limited (SPTL); and
- Scottish Hydro-Electric Transmission Limited (SHETL).

1.2. The existing transmission price control, Transmission Price Control Review 4 (TPCR4), covers the five years from 1 April 2007 to 31 March 2012. An agreement on new revenue allowances will need to be in place from 1 April 2012.

Process to date

Consultation and decision on timing of TPCR5

1.3. In October 2009 we published a consultation[3] ('the October consultation') setting out, and seeking views on two broad options for the timetable and approach for taking forward the next transmission price control review (TPCR5):

- **Option 1:** Implement TPCR5 from 1 April 2012, incorporating the conclusions from the RPI-X@20 project, as far as practicable.
- **Option 2:** Implement TPCR5 from 1 April 2013, so that the conclusions from RPI-X@20 can be more fully implemented and extend the existing price control regime (TPCR4) for a further year.

[3] Approach and timetable options for the next Transmission Price Control Review (TPCR5): Consultation (130/09)
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/Documents1/Approach%20and%20timetable%20options%20for%20taking%20forward%20the%20next%20Transmission%20Price%20Control%20Review%20FINAL.pdf

1.4. In the October consultation we indicated a provisional preference for adopting Option 2.

1.5. On 21 December 2009 we published a short letter providing notification of the Authority's decision to delay the start of TPCR5 until 1 April 2013. We subsequently published a document on 15 February 2010[4] setting out the reasons for the Authority's decision to delay implementation of TPCR5 and to implement a one-year rollover of the existing control (TPCR4). The February document also outlined early thinking on the approach and timetable that would be followed in taking forward TPCR5.

1.6. The decision to delay implementation of TPCR5 makes it easier to implement improvements to the regulatory framework identified through the RPI-X@20 project, rather than those improvements being delayed until a future regulatory agreement. In our February document we noted this would provide for a more stable foundation for the development of TPCR5. We expressed our opinion that the long-term advantages of fully reflecting the conclusions of the RPI-X@20 project outweighed any short-term downside the introduction of an additional price control process may pose.

March consultation on scope of the rollover

1.7. In March 2010 we published a consultation on the scope of the adapted rollover[5]. The document outlined the objectives of the rollover process along with our 'minded to' approach in each of the key policy areas, our proposed scope of the rollover.

1.8. The timing and the reduced duration of the rollover price control imply the need for specific objectives for the rollover process. These objectives reflect the need for the price control to be proportionate with a one-year control, to facilitate an efficient process to develop TPCR5, to reflect recent developments in policy, and avoid any delay in critical investment. These objectives are discussed in detail in Appendix 2 of this document.

1.9. The following table summarises the 'minded to' approach to key rollover issues we communicated in our March Consultation Paper:

[4] Approach and timetable for the next Transmission Price Control Review (TPCR5): decision document (21/10)
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/Documents1/TPCR5%20Approach%20and%20Timetable%20-%20Decision%20Document%20-%20FINAL.pdf
[5] Transmission Price Control 4 – Scope of "Adapted Roll-over" (2012-13): Consultation (34/10)
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4%20roll-over/Documents1/TPCR4_Rollover_Scope_ConDoc_FINAL.pdf

Table 2 Summary of 'minded to' position detailed in March consultation

Aspect	**Proposed approach**
Capex	• A complete assessment of historical capex will be undertaken as part of the full price control review. • Focus on forecast capex with an investigation of historical capex only where it is necessary to support scrutiny of forecast capex. • Capex incurred during TPCR will enter the provisional RAV during the rollover on an indicating basis.
Opex	• Set opex allowances based on the average of costs in the first three years of the control, with consideration of forecast opex and the addition of a company-specific efficiency factor.
Financial Issues	• *Cost of Capital / allowed return*: update the cost of capital for changes in market assumptions. • • *Tax*: review capital allowances and the tax calculation to reflect the changes since TPCR4 but defer any tax claw back for excess gearing until TPCR5. • *Pensions*: adopt the principles established during the review of pension costs as initially set out in DPCR5, where possible. • *Capitalisation and depreciation*: no change from TPCR4. • *Calibration:* Construct a financial model and conduct return on regulated equity (RoRE) analysis as per DPCR5.

1.10. Submissions were received from the following organisations; Centrica Energy, EDF Energy, Consumer Focus and the trustees responsible for National Grid's pension schemes in addition to the three transmission licensees[6]. A summary of these responses can be found in Appendix 3.

1.11. On the whole respondents reacted positively to the proposed proportionate approach to the rollover, and generally were aligned with our initial thoughts on the scope of the rollover. There were a small number of items on which stakeholders disagreed with our 'minded to' position. The most significantly areas of disagreement related to our proposals to review the allowed return/cost of capital and to adopt the pension principles developed during the recent pensions review.

Regulatory activities and their impact on the "rollover"

RPI-X@20

1.12. The RPI-X@20 project is our detailed review of the future regulatory framework for electricity and gas transmission and distribution networks. We are considering whether the existing frameworks are fit for purpose in terms of meeting the challenges that the energy sector faces and, in particular, the needs of existing and

[6] National Grid's response represented both electricity and gas transmission.

future consumers. In line with our original timetable for the review, we intend to make our recommendations on a future regulatory framework to the Gas and Electricity Markets Authority (GEMA) in summer 2010. We plan to consult on these recommendations over the summer, with a view to reaching a decision and bringing the project to a close in the autumn.

1.13. We published our 'Emerging Thinking' consultation[7], including a consultation on financeability and third party right of challenge, in January 2010. We set out, for consultation, proposals for a potential new regulatory framework. Since then we have undertaken further analysis on the detail of how a future regulatory framework might work, considered legal implications of our thinking and reviewed and considered arguments made in the responses to the consultation. We published reports from Frontier Economics on benchmarking and on outputs, and a report from Cambridge Economic Policy Associates (CEPA) on financeability. We also published two Ofgem working papers in May 2010 on two key aspects of the price control, namely the length of the price control and the financeability package. Responses to these working papers and consultant reports can be found on our web forum. More detail on the RPI-X@20 project is provided in appendix 4.

1.14. The decision on the new regulatory framework will be implemented in TPCR5 and GDPCR2. The RPI-X@20 conclusions will not impact on the rollover, save in so far as we will aim to ensure that decisions in the rollover are consistent with expected changes to be made in TPCR5.

Enhanced TO incentives

1.15. Following completion of the joint Ofgem/Department for Energy and Climate Change (DECC) Transmission Access Review (TAR)[8], we have taken forward work to develop funding arrangements for investment by the electricity transmission companies which anticipate future demand from generators. On 19 January 2010 we set out our Final Proposals to facilitate additional investment during the current transmission price control period (TPCR4)[9]. In this document we reiterate that we will fund efficient costs, up to the end of TPCR4, for pre-construction work for all projects and construction work for specific projects[10]. We have provided initial funding under this framework for construction expenditure incurred up to the end of 2011/12, when the current price control expires. Over this period, the Transmission Asset Owners (TOs) currently plan additional investment of around £1bn across all projects, representing around one-fifth of the overall £5bn investment programme the companies believe is needed. We indicated that future funding arrangements,

[7] Regulating energy networks for the future: RPI-X@20 Emerging Thinking - January 2010 Ref: 05/10
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=emerging%20thinking.pdf&refer=Networks/rpix20/publications/CD
[8] More information on TAR is available on Ofgem's website:
http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Pages/Traccrw.aspx
[9] Transmission Access Review – Enhanced Transmission Investment Incentives: Final Proposals (04/10)
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=204&refer=Networks/Trans/ElecTransPolicy/tar
[10] Pre construction funding was granted for all projects so as not to delay any critical investment. This approach was adopted following the publication of the ENSG report:
http://www.ensg.gov.uk/assets/ensg_transmission_pwg_full_report_final_issue_1.pdf

beyond 2011/12, would be considered separately. The treatment of funding beyond 2011/12 is discussed in Chapter 2.

1.16. Our January 2010 Final Proposals document confirmed the initial tranche of planned investment which we intend to fund at this stage, which amounts to pre-construction expenditure of £78m and construction expenditure of £241m in 2010/11 for projects planned to commence construction prior to 1 April 2011[11]. On 17 March 2010, we published an open letter[12] setting out an approach and timetable for additional work in relation to projects requiring funding in 2011/12. We will assess further funding, including additional projects, when funding requests are received through the framework outlined in our final proposals.

Pensions review

1.17. The payments made by energy network operators into pension schemes represent a significant portion of their business costs and are reflected in charges levied on system users and ultimately in bills paid by energy consumers. Many of these costs relate to defined benefit pension scheme commitments whose funding requirements can vary over time. There can also be challenges in gauging how efficiently these costs are managed.

1.18. To address these issues we carried out a series of consultations, during 2008 and 2009, aimed at validating our existing pension principles and refining the way they would be applied to network operator price controls going forward. The results were used in setting pension cost allowances for electricity distributors in DPCR5. We clearly communicated at the time that these principles would be adopted in subsequent price controls across gas distribution and transmission.

[11] This is in addition to £12.5m we allowed in February 2009 for a range of preconstruction activities. For more information see the final proposals open letter: http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Documents1/090227TOShortTerm%20Measures.pdf
[12] For more information please see the following link: http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Documents1/TOIncAdditionalWork.pdf

This document

1.19. This document communicates our decision on the scope of the 'adapted rollover', outlining exactly which elements of a normal price review we propose to undertake, and which we propose it would be more appropriate to defer until TPCR5. These decisions were driven by our objectives, taking into account submissions in response to our March consultation document. Whilst we are making our decision on a number of scope issues, there are policy issues on which we request feedback. Therefore, we are deferring a decision on these issues until later in the process.

1.20. The remainder of the document is structured as follows:

- ***Chapter 2*** details our final decisions on our approach to capex and opex allowances, our treatment of historical capex, and our approach to existing and new transmission policies. In this chapter we also outline details of the four outstanding policy issues on which we wish to consult.

- ***Chapter 3*** sets out the financial decisions we have taken on the approach to allowed return, capitalisation and depreciation, tax and pensions.

- ***Chapter 4*** sets out the process that will be followed in arriving at our final price control proposals, outlining our approach to stakeholder engagement, along with how and when submissions from the TOs will feed into the process.

*Supplemen*tary information can be found in the following appendixes:

2. Scope of the rollover

Chapter Summary

Given the limited price control period, our stated objectives of proportionality, and the need to avoid any encroachment on decisions likely to arise from the RPI-x@20 review, it is not appropriate to review each element that would be assessed during a full price control.

Chapters 2 and 3 represent our final decisions on the majority of the scope of the 'adapted rollover'. This chapter focuses on historical and future expenditure and specific policy decisions, whilst a full discussion of our final decision on financial items can be found in section 3. We wish to use this opportunity to engage stakeholders to offer views on our approach to SO internal incentives, electricity revenue drivers, gas capacity incentives and the SF6 incentive.

Question Box

Question 1: Do you think it is appropriate that the revenue drivers should be used in the rollover year to determine allowed capex for the electricity TOs?

Question 2: Do you believe the SF6 incentive scheme should continue into the rollover year and, if so, is the current structure appropriate or should it be modified?

Question 3: NGG have incentives to deliver capacity in a timely manner and we hope to continue this type of incentive for the rollover year. How do you feel this can best be achieved during the rollover year?

Question 4: Do you believe that the current structure of the SO internal incentive scheme should roll over (accounting for updates to external SO incentive parameters as is currently the case)?

Capex

2.1. The assessment of historical and forecast capex is a key part of any price control. An assessment of **historical capex** is essential to protecting customers as it allows us to come to a view on whether expenditure during the last price control period was efficient and appropriate. Historical capex is also used to inform judgements about the validity of the TOs capex projections and is an important input to the setting of the opening Regulatory Asset Value (RAV) for the new price control period. To fulfil our statutory duties and allow revenue for efficient investment it is crucial we have confidence in, and fully understand, the TOs' **capex forecasts.**

2.2. In our March consultation paper we indicated our intention to follow an approach of *"focusing on forecast capex with an investigation of historical capex only where it is necessary to support this forward-looking assessment".* Having considered the responses to our consultation we remain of the view that this is the correct approach for the rollover. We set out below how we will approach historical and forecast capex, as well as 'logged up' costs.

2.3. ***Historical capex:*** All capex incurred during TPCR4 will be added to the provisional opening RAV for 2012 on an indicative basis. A comprehensive review of this expenditure will take place as part of TPCR5. During this comprehensive review, if we identify ineligible or inefficiently incurred capex, we will make appropriate adjustments to the RAV and the TPCR5 settlement. This will ensure the TOs do not benefit unduly from our decision to delay a full assessment of their capital expenditure. We will only undertake an investigation into historical capex where we feel an understanding of a company's historical performance would contribute materially to our assessment of their future capex forecasts.

2.4. ***Forecast capex:*** We will undertake a proportionate review of the forecast capex information which the TOs provide as part of their business plans and regulatory reporting pack (RRP) returns to ensure that the settlements provide value for money for users of the transmission system[14]. High-level forecasts of projects funded under the TO incentives mechanism will be included, though detailed analysis of these projects will take place independently of the rollover exercise. We are committed to ensuring that efficient investment will be able to proceed during the rollover period without placing a significant regulatory burden on the TOs.

2.5. ***Logged up costs:*** A number of areas were identified during the last price control review where we were expected to make investments during the TPCR4 but the cost was unknown. Rather than attempt to predict these costs, logging up mechanisms were included as part of the price control settlements. Subject to an efficiency review, these costs would be added to the RAV and an appropriate revenue adjustment made on a NPV neutral basis so that the companies are not penalised for the delay in allowing the investment.

2.6. As we have decided not to carry out an efficiency review of historical expenditure until TPCR5 we consider that it is appropriate to extend the logging up mechanisms for the rollover year. No allowance for these costs will be made as part of the settlement and they will not be included in the RAV. The assessment of the efficient costs, RAV additions and appropriate revenue adjustments for the logged up items will be made at TPCR5. Given the magnitude of these costs and that the adjustments will be made on an NPV neutral basis we do not consider that logging up for an additional year will have a material impact on the finances of the licensees.

Opex

2.7. A detailed assessment of opex generally involves using a combination of the bottom-up cost analysis of specific activities, expert review and top-down benchmarking of total opex. In previous rollovers we have generally adopted a simplified approach to our assessment of opex based on top down benchmarking

[14] We intend on leveraging the RRP as much as possible to reduce regulatory burden. This process is detailed in chapter 4

with adjustments made to reflect efficiency savings. As communicated in our March Scope Document we consider it is proportionate and appropriate to adopt such a high-level approach to the rollover.

2.8. The allowance made for opex in our rollover settlement will be informed by actual expenditure in up to the first four years of TPCR4 (2007 to 2011). We will also give consideration to the TOs' opex forecasts. We will make a company specific adjustment to account for the scope for improved efficiency.

Transmission policy

Revenue drivers – Electricity

2.9. A suite of revenue drivers for the electricity licensees was introduced as part of TPCR4 to adjust automatically the TOs' revenues in the light of changing patterns of demand for network capacity. To facilitate this mechanism, Unit Cost Allowances (UCAs) and project-specific allowances were defined at the start of the price control. The revenue that would be generated in the event that the drivers were triggered was based on information about TPCR4 projects. The UCAs were calculated using a sample of projects scheduled to be built during the period 2007-12 and were fixed for the period whilst the project-specific costs were based on individual schemes.

2.10. In our March consultation document we indicated that we were not minded to introduce any new revenue drivers for the rollover, but would update the UCAs and project-specific parameters where necessary. We do not consider it appropriate to make a decision on the use of revenue drivers without a full understanding of the licensees' capex forecast during the rollover year and the extent to which the existing revenue drivers are suitable or not.

2.11. The uncertainty surrounding expenditure that revenue drivers were introduced to address should be significantly less during a one year price control, and it may be more appropriate to suspend the scheme in favour of a base capex allowance for one year. The logical point to make this decision is we have had an opportunity to consider the forecast business plan questionnaires (FBPQs) submitted by the TOs. At that point we will be able to assess whether the existing revenue drivers would over or under-reward the TOs if they were to remain in place for an additional year. Whichever approach is adopted we will clearly communicate which projects are associate with each funding mechanism and ensure projects do not receive duplicated funding. We will also consider the extent to which the revenue drivers can co-exist in their current form with the "connect and manage" regime that government intends to implement in July 2010.

Revenue drivers – Gas

2.12. For gas, the revenue drivers provide funding for load related expenditure for a fixed five-year period in the case of capacity signalled after 2007 (this may be longer for capacity signalled prior to 2007). Load related expenditure is then assessed for efficiency before it is included in the RAV. Some incremental investments were expected to be assessed for efficiency and included in the TO RAV from April 2012.

2.13. The approach documented in our March consultation was to conduct the efficiency assessment at TPCR5 and make any adjustments to the TO RAV retrospectively; we have amended this approach slightly to bring it in line with the general approach to capex. Capex incurred during TPCR4 will enter a provisional TO RAV at the start of the rollover year. A full efficiency assessment will take place as part of TPCR5 and, if it is necessary to disqualify any capex, the settlement and TO RAV will be adjusted accordingly at TPCR5. As detailed in the section on capex, 'logged up' costs will continue to log up and enter the TO RAV at TPCR5 following a full efficiency review.

Incentives (Electricity and Gas)

2.14. In TPCR4, a set of incentives were introduced to encourage innovation from all the TOs and to reduce emissions of Sulphur Hexafluoride (SF6) by the electricity licensees. The electricity reliability incentive that existed prior to TPCR4 was also enhanced.

2.15. Through the SF6 incentive electricity licensees are incentives to minimisation of the leakage of SF6 gas from their transmission assets. In deciding whether or not to continue with this incentive into the rollover year we will consult with stakeholders and undertake an assessment of its success to date to determine whether the cost associated with additional SF6 loss reductions is in the interests of existing and future customers.

2.16. Innovation is encouraged in both electricity and gas licensees under the Innovation Funding Incentive (IFI) mechanism. In response to our March consultation one TO suggested that the revenue available through this scheme should be increased from the current level (which is contained by a ceiling set at 0.5% of turnover). We feel any adjustment would constitute a change of policy and will leave this incentive unchanged during the rollover year.

2.17. The reliability incentive is based on parameters which will need to be extended into the rollover year, again we feel any change to the structure of this scheme would constitute a change of policy and will only be updating the parameters into the rollover year.

SO internal incentive scheme

2.18. During TPCR4 we determined internal SO allowances. These allowances are provided by the SO internal incentive scheme and cover internal costs such as staff and IT[15]. In keeping with a proportionate approach we will maintain the structure of the internal SO incentive scheme as much as possible, updating the parameters to

[15] This mechanism is distinct from the external SO Incentive scheme that applies to the costs of balancing the system.

ensure alignment with the objectives and incentive structure of the external SO incentive scheme.

Parallel policy activities

2.19. Respondents to our March consultation paper comments on issues and funding mechanisms that fall outside of the scope of this rollover. The following sections clarify our position on these issues.

2.20. **Gas: Baseline capacity obligations:** NGG has licence obligations to make available specified amounts of capacity at the various entry and exit points. The March consultation document did not outline specifically how these would be treated although it was implicit that these obligations would not be changed for the rollover. One respondent wanted an investigation of the baseline obligations at Dynevor Arms (which is an LNG storage site that NG LNG has closed down), since NGG still has entry capacity baseline obligations there. We agree that the baseline obligation at Dynevor Arms needs to be reallocated. Whilst this issue does not specifically relate to the price control we will be considering it at the same time as the rollover.

2.1. **Gas: Fleetwood entry capacity revenues:** Fleetwood is a new entry point on the gas transmission system, the need for which was signalled through the September 2006 auctions. It is scheduled to provide capacity from October 2010. However, the storage project behind this entry point has been refused planning consent. NGG has not reinforced the national transmission system in the manner required to provide this additional capacity, as it did not want to invest in stranded assets; in this regard, it would appear to have acted in an efficient manner. But, NGG maintains that it should still be entitled to the incentive revenues relating to this project, and intends to recover this from all shippers through the commodity charge. Following the publication of our March consultation paper one respondent considered that the treatment of entry capacity revenues from the Fleetwood entry point should be addressed as part of the rollover. Our initial view is to address this issue independently of the rollover process; however, we agree that it may be appropriate to consider Fleetwood revenues as part of the rollover process if circumstances prevent a full consideration of this matter through other routes.

2.2. **Electricity: Enhanced TO incentives work:** Our work on enhanced TO Incentives will continue independent of and in parallel to the rollover. On 17 March 2010 we published an open letter setting out our approach and timeline for consideration of projects that will require construction funding in 2011/12. Given our decision to progress the TO incentives project independently of the rollover, in due course, we will publish a further open letter setting out our approach and timetable for projects requiring funding (both pre-construction and construction) in 2012/13.

2.3. As set out in the following section, whilst the TO Incentives work will be progressed independently and follow its own programme, our decision to review the cost of capital for the rollover will have an impact on the allowed return for projects within the TO Incentives mechanism.

3. Scope of the rollover: Financial issues

Chapter Summary

This chapter sets out our final decisions on financial issues relating to the one-year rollover.

Financial model and return on regulatory equity (RoRE)

3.1. As with previous price control reviews, we propose to construct a financial model to ensure the rollover proposals will allow efficiently run transmission companies to finance their activities. Stakeholders indicated broad support to this approach in response to the March consultation document. The model will be updated from that used at TPCR4 to include developments embodied as part of DPCR5.

3.2. The March consultation document also clarified our intention to use RoRE as a measure to assess the range of returns on regulated equity that investors might expect to earn from the price control package as a whole. This analysis is useful in assessing whether the package strikes an appropriate balance between attracting necessary investment and protecting the interests of existing and future customers. This approach was used during the recent electricity distribution price controls, and will, again, be used during the rollover.

Allowed return

3.3. The determination of allowed return is a key aspect of any price control review because adjustments to the allowed return may have a significant impact on the revenues granted to the TOs. In determining the allowed revenue we are required to strike a balance between ensuring sufficient allowance is made for the TOs to service their debts and attract sufficient equity, whilst protecting the interests of existing and future customers. A number of factors contribute to this determination including the overall risk of the price control package, debt rates and the investment environment at the time.

3.4. The rate of return allowed under TPCR4 was a vanilla[16] weighted average cost of capital (WACC) of 5.05%. Given the potential materiality of any change in the cost of capital it is appropriate that this critical input is examined and updated if necessary. Our March consultation document suggested this approach stating that updates would be made for changes in market assumptions, while other inputs would be reviewed and updated where necessary.

3.5. Any update to the allowed return will impact other areas of Ofgem's policy. The TO Incentives work (discussed above) uses the TPCR4 cost of capital to determine

[16] The 'vanilla' WACC is the Weighted Average Cost of Capital without any adjustment for tax.

allowed revenues. Whilst we are committed to retaining separation between TO Incentives and the rollover, funding under TO incentives would continue to use the prevailing allowed return (i.e. current the TPCR4 value until end 31 March 2012, then the updated Cost of Capital to 31 March 2012). Additionally, the Transmission Investment for Renewable Generation (TIRG) mechanism, also uses the prevailing transmission price control allowed return to derive revenues in the period after construction has finished up to the end of the asset life.

3.6. We have carefully reviewed the comments of licensees, who were opposed to a review of the cost of capital, but consider that a high-level review of all of the inputs into the cost of capital constitutes a proportionate approach to a one-year control and would be consistent with Ofgem's duties. We remain of the view that the cost of capital should be set at a fair and appropriate level, which could be higher, lower or the same as the current value.

Capitalisation and depreciation

3.7. Revenue allowances are set to ensure that costs are recovered over the assumed regulatory life of the assets. Price controls provide allowances for depreciation and return on assets within the RAV. The policies adopted for capitalisation and depreciation can have a significant impact on the revenues of a company in any particular price control.

3.8. In TPCR4, for all electricity transmission companies, we used regulatory asset lives of 20 years to determine ***depreciation*** for post-vesting assets, once the pre-vesting assets became fully depreciated. TPCR4 also provided for company-specific smoothing adjustments in relation to assets built between post-vesting but before the start of the price control period to align their regulatory asset lives to this 20 year period. Gas transmission uses straight-line depreciation over 45 years for post-vesting assets with sum of digits depreciation[17] on pre-vesting assets. In our March consultation document, we outlined our intention to leave the approach to depreciation unchanged as the approach to depreciation is under review as part of the RPI-X@20 project. Respondents to the consultation agreed with this approach.

3.9. In TPCR4 the ***capitalisation*** policy followed that defined by each TO, and we intend to extend this approach into the rollover period. As with depreciation, we consider that any changes to capitalisation policy for the rollover period are likely to foster greater uncertainty as these issues are being considered as part of the RPI-X@20 project.

Tax

3.10. In deriving the TOs allowed revenues an allowance is made for taxation. For TPCR4 this allowance was based on the prevailing tax legislation and capital allowance levels. A significant amount of work has been undertaken recently on the

[17] a way of front loading the depreciation of an asset so that the majority of its value is lost in the early years of its life.

treatment of taxation as part of DPCR5. Following the March consultation document we have decided to maintain our provisional approach.

3.11. We will determine expected tax costs using applicable capital allowances and tax rates, using the same tax calculation methodology as was implemented at DPCR5. This will reflect recent changes in capex and pensions expenditure. Adoption of this approach is also likely to facilitate the consideration of these issues during TPCR5. We do not consider the introduction of policy changes, such as the tax trigger[18] that was implemented as part of DPCR5, would be consistent with the principles of the decision for the one-year rollover set out in this document.

Pensions

3.12. Payments made by the TOs into pension schemes represent a significant cost. In 2008 and 2009 we undertook a review of the treatment of pension costs, the results of which were fed into the DPCR5 final proposals. In the March consultation document, we indicated that we were minded to incorporate these proposals into the rollover, as far as possible. Having considered the responses to the consultation we remain of the view that the adoption of these principles in the rollover is appropriate. The key principles that will be adopted during the rollover are:

3.13. ***15 year notional deficit recovery period:*** Over recent years, deficits have developed in each of the TOs' pension funds. We are committed to funding the repair of these deficits, providing the costs of doing so are no higher than they reasonably need to be. In line with our pensions review we will provide for recovery of the deficit (as it is estimated as at 31 March 2012) over a notional 15 year period. Whilst we acknowledge the concerns of TOs and trustees about the length of this period the pensions review concluded that this time period represented an appropriate balance between the concerns of trustees and affordability for customers.

3.14. ***"Truing up" of deficit payment from TPCR4:*** At the start of TPCR4, NGG and NGET's pension schemes were in deficit and the price control settlement included an allowance for deficit recovery. (The Scottish TOs' pension funds were in surplus at the time so no deficit recovery allowance was necessary.) To date in TPCR4, NGET and NGG's deficit recovery payments have exceeded those allowed at the start of the price control and in addition the Scottish TOs are about to commence deficit recovery payments, for which no ex ante allowance was granted. We consider that it is appropriate that our consideration of allowed revenue takes account of the need to "true up" these overpayments, subject to an efficiency review. In our March consultation document we indicated that we were minded to defer any "true up" until TPCR5. Having considered the responses to our consultation and to optimise work across the rollover and TPCR5, we now consider it appropriate to bring forward the pensions efficiency review. As a consequence **the "true-up" can form part of the rollover**, subject to timely receipt of the pensions valuation data. "True-up"

[18] This mechanism was introduced in DPCR5 and triggers a revenue adjustment under certain circumstances to reduce the risk to DNOs from material changes in tax payments beyond their control arising from, for example, legislative change.

allowances arising from deficit recovery payments during TPCR4 will therefore begin during the rollover and will take place over a number of years extending into TPCR5.

3.15. ***Base allowance for ongoing costs:*** The base revenue allowance for ongoing contributions will be based on the latest actuarial recommendations.

4. Next steps and Stakeholder engagement

Chapter Summary

This chapter sets out the process that will be followed in arriving at our final price control proposals, outlining our approach to stakeholder engagement, along with how and when submissions from the TOs will feed into the process.

Question Box

Question 1: We are in the process of finalising our approach to stakeholder engagement for the rollover period, do you agree with the proposed approach detailed in this section?

Next Steps and timetable

4.1. We will continue to follow an open and transparent process to arrive at our final price control proposals. In developing the timetable we have worked to ensure sufficient time is allowed for all interested parties to fully engage with the process. We have taken care to be mindful of the other regulatory processes running in parallel and the need to develop a process proportionate with a one year control. The table below indicates the key dates for the rollover:

Table 3 Key dates for TPCR4 Rollover

2010	
July	**Publish "Scope decision and consultation paper"** Issue FBPQ (26/7)
October	Receive FBPQ (29/10)
2011	
Jan	Conduct cost visits
March	**Communicate updated position**
July	**Publish initial proposals**
December	**Publish final proposals**
2012	
March	Issue amended licence (31/3/12)

Stakeholder engagement

4.2. We intend to engage effectively with stakeholders throughout the rollover process to ensure decisions are reached in a transparent and consultative manner. To date, this engagement has taken the form of publications in advance of and subsequent to the completion of each major rollover activity, along with Ofgem-led workshops and presentations to user groups and the TOs.

4.3. Ofgem recently led workshops with TOs and other interested parties including Consumer Focus. Through these fora and the March consultation document we have solicited input from stakeholders on how our engagement with them could best be managed. The key messages we have received were:

- The levels of engagement should be proportionate with a one year control, particularly in light of the number of regulatory processes taking place in parallel.

- The engagement process for the rollover (2012/13) and the subsequent price control review (TPCR5) should be clearly delineated, to avoid any confusion.

- A strong desire to see an integrated timetable detailing the regulatory processes on which they may wish to comment. This timetable is detailed in chapter one of this document.

4.4. These messages in conjunction with the objectives for the review have shaped our approach to stakeholder engagement.

Ofgem-led workshops

4.5. We hosted a workshop on 13 April 2010 where stakeholders were invited to comment on the objectives and our 'minded to' positions outlined in the March paper[19]. Presentations were given by Ofgem and each of the TOs to a wide audience including representation from Consumer Focus, Electricity Generators and Suppliers and Gas Shippers and Suppliers.

TO involvement

4.6. In line with the objectives of the review and taking forward the approach and lessons learned in DPCR5 we will encourage the TOs to become actively involved in the stakeholder engagement and interaction process.

[19] Adapted rollover stakeholder workshop presentations:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=4&refer=Networks/Trans/PriceControls/TPCR4 roll-over

Challenge Groups

4.7. Stakeholders were consulted specifically on the use of a consumer challenge group. While it was considered there may be some merit for a challenge group covering the rollover, particularly given this would be a precursor to TPCR5, the overall response to this proposal was that this would be disproportionate given the limited scope and timeframe of the price control. Instead of using such a group we intend to maintain a close liaison with Consumer Focus, Consumer Focus Scotland and Consumer Focus Wales, convening specific workshops on funding and consumer issues as and when they arise.

Bilateral meetings

4.8. We will engage individuals, groups and agencies at times for bilateral discussions. These meetings will provide an opportunity for detailed discussion on specific matters and we welcome requests for such meetings from interested parties.

Panels and working groups

4.9. Previous price controls have demonstrated the benefits of utilising working groups to discuss and develop views on key issues and areas of analysis. We intend to follow this approach, issuing invites and scheduling sessions in due course. The final list of topics will depend on where most discussion is required but is likely to include Pensions and Cost of Capital.

TO submissions and final proposals

Forecast Business Plan questionnaires and Regulatory Reporting Packs

4.10. A key input to the Price review is the submission of Forecast Business Plan Questionnaires (FBPQs) by the TOs, detailing their projected expenditure over the price control period, associated outputs and narrative to explain their forecasts, including any key assumptions that have been made. We are holding discussions with the TOs to develop the form of the questionnaires. The next step following the publication of this document will be the formal issue of the FBPQs by 30 July. The licensees will be expected to return these questionnaires by 29 October. The licensees will be expected to take into account discussions held with Ofgem to date, the outcomes of any stakeholder engagement progressed by the licensees, and the policy decisions outlined in this paper. We will carry out an initial review of the forecasts in November and December 2010 and engage with the licensees through cost visits in January 2011 for any clarification or additional information that may be required. We will then conduct further analysis of the forecasts following the visits in order to assess appropriate cost requirements for the licensees for Initial and Final Proposals.

4.11. The Regulatory Reporting Pack (RRP) is an annual submission the licensees are mandated to make to Ofgem as a condition of their license, to allow their actual expenditure throughout the price control period to be compared to that agreed at the preceding price control. This also allows further analysis of the TO costs to be carried out on an annual basis. The next submission is due by the end of July 2010 and this information will be one of the key resources used as part of the rollover work.

Initial and final proposals

4.12. We intend to publish a consultation on our proposals in July 2011 a period of consultation will follow. Following on from this publication and any subsequent changes the final proposals will be published in December of the same year to allow time to implement any necessary licence changes by 1 April 2012.

Appendices

Index

Appendix 1 – Consultation response and questions from this paper

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 11th August 2010 and should be sent to:

- TPCR4.Rollover@Ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Any questions on this document should, in the first instance, be directed to:

David Hunt
Ofgem (Transmission & Governance Team)
9 Millbank
London
SW1P 3GE
0207 901 7429
TPCR4.Rollover@Ofgem.gov.uk

CHAPTER: Two

Question 1: Do you think it is appropriate that the revenue drivers should be used in the rollover year to determine allowed capex for the electricity TOs?

Question 2: Do you believe the SF6 incentive scheme should continue into the rollover year and, if so, is the current structure appropriate or should it be modified?

Question 3: NGG have incentives to deliver capacity in a timely manner and we hope to continue this type of incentive for the rollover year. How do you feel this can best be achieved during the rollover year?

Question 4: Do you believe that the current structure of the SO internal incentive scheme should roll over (accounting for updates to external SO incentive parameters as is currently the case)?

CHAPTER: Four

Question 1: We are in the process of finalising our approach to stakeholder engagement for the rollover period, do you agree with the proposed approach detailed in this section?

Appendix 2 – Objectives of the rollover

1.1. Our intention is that the rollover should have the minimum scope consistent with our duties and the principle of better regulation. We consider that this will ensure that the rollover represents a proportionate intervention that minimises the risk of making decisions which are inconsistent with the conclusions of the RPI-X@20 project. We only propose to deviate from this approach:

- To reflect agreed policy developments; and/or
- If there are areas of work we could undertake now which would smooth the path of TPCR5 but which will be independent of the conclusions from the RPI-X@20 project.

1.2. We propose that the objectives of the rollover should be as follows:

- **To protect the interests of existing and future consumers[20]**– Consumers' interests are protected by having high quality transmission networks supporting a high standard of security of supply delivered at an efficient cost. Therefore, while the review is a 'rollover' it should provide an appropriate level of scrutiny of transmission companies' forecasts, sense-checked against their historical performance.

- **To be consistent with Ofgem's wider statutory duties** – including the need to secure that licence holders are able to finance their ongoing activities which are the subject of obligations on them. When carrying out our duties we also have regard to the need to contribute to the achievement of sustainable development and to the effect on the environment from regulated activities. We also have regard to the need to secure that all reasonable demands for electricity and gas can be met. The Authority shall also have regard to statutory guidance on social and environmental matters issued by the Secretary of State. A revised version of its Social and Environmental Guidance was formally issued to the Authority on 18 January 2010.

- **To be proportionate to a one-year control and to minimise regulatory burden** – Recognising that the proposals will only apply for one year and that the review will extend the existing control mechanisms, the review should not introduce fundamentally different arrangements relative to the preceding price control. To develop new arrangements in the year before the introduction of the new framework (resulting from the RPI-X@20 project) would create greater uncertainty and undermine the purpose of the rollover. Our approach should also seek to maximise administrative efficiency in terms of the resource requirements and costs of both Ofgem and the industry. Relevant considerations include the number of consultation papers published and the requirement for consultancy support.

[20] Consumers' interests have been clarified by the Energy Act 2010 as their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

- **To reflect recent developments in policy** – There have been a number of areas where changes have been made to the process for calculating key price control parameters in the period since the final decisions for TPCR4. For example, Ofgem has recently completed a review of the treatment of pension costs that will affect all future network price controls and in setting DPCR5 Ofgem gave consideration to the cost of capital. The DPCR5 process also built in arrangements for greater stakeholder engagement. In addition, there is a need to update certain price control parameters, for example, the revenue drivers in light of: (a) our work on TO incentives[21]; and (b) the Connect and Manage[22] access regime which is expected to be implemented by Government, to appropriately reflect the relationship between investment and the volume of generation connected. While it may be disproportionate to reflect all changes in policy in the one year rollover, any proposal for the rollover should be considered in the context of avoiding inconsistency with recent developments in policy.

- **Not to delay critical investment** – A large amount of transmission investment is needed in the near future, including facilitating the achievement of the Government's carbon targets. For electricity, this investment has been highlighted in a study by the Electricity Networks Strategy Group[23], and we accept that requirements for additional investment may be identified. It is critical that no necessary investment is delayed by our decision to roll over TPCR4 until 31 March 2013.

- **As far as practical, to enable an efficient process to develop TPCR5** – Whilst we intend to manage the rollover as a distinct exercise, separate from our work on TPCR5, we recognise that there may be an interaction with work that would subsequently have to be taken forward as part of TPCR5. We will ensure that the rollover does not encroach upon decisions that will be made in the light of the RPI-X@20 project; however, we will look for areas where non-overlapping work undertaken as part of the rollover will either remove or reduce the need to perform certain tasks as part of TPCR5.

[21] Our TO incentives work was taken forward following the Transmission Access Review. http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Pages/Traccrw.aspx
[22] Details of the consultation on Connect and Manage can be found on the DECC website: http://www.decc.gov.uk/en/content/cms/consultations/improving_grid/improving_grid.aspx
[23] The ENSG study is available on the ENSG website: http://www.ensg.gov.uk/assets/ensg_transmission_pwg_full_report_final_issue_1.pdf

Appendix 3 – Summary of consultation responses

1.1. This section contains a summary of the consultation responses to the "Scope of the Adapted Rollover" paper issued on 15th March 2010. The full set of responses is available on our website at www.ofgem.gov.uk.

1.2. ***Respondents:*** Seven responses were received. Along with those from each of the TOs submissions were also received from Centrica Energy, EDF Energy, Consumer Focus and the Trustees responsible for National Grid's pension schemes.

1.3. ***Concept of rollover and objectives:*** There was alignment amongst the TOs in their agreement with the concept of proportionality and that no new transmission specific policies are introduced until TPCR5 when the RPI-X@20 work will have completed. Centrica Energy and Consumer Focus did not agree with the delay of TPCR5; Consumer Focus expressed concern that less scrutiny will be applied when examining costs for a rollover year. They were additionally concerned that Ofgem's position may be weakened by the reduction in the credibility of a threat to take a licensee to the Competition Commission as a result of the short price control period and light touch approach. Now it has been determined that a rollover will be implemented both support the concept of proportionality.

1.4. National Grid highlighted the need for further analysis of SO costs in light of challenges associated with recruitment, IS and market reform.

1.5. ***Capex:*** The TOs were unanimous on the subject of capex requesting that investigation of historical capex be delayed until TPCR5. National Grid and SHETL requested that overspend and 'logged up' capex for the current period be entered into the RAV in 2012. Consumer Focus however noted with concern that NGET and SHETL exceeded their capex allowances to March '09 and advocates no increase in allowance for the rollover period. With regard to future capex, Scottish Power deems it inappropriate to use new modelling techniques for non-load since a 5 year data set is required stating a preference to assess and rollover individual schemes.

1.6. ***Opex***: All of the TOs expressed concern about how the efficiency factor would be derived while rolling forward the opex allowance, with two citing factors for consideration in its determination. These were upwards pressures as a result of a larger Network for SHETL, whilst for National Grid it is an increase in opex associated with research to extend asset lives. In addition to concerns over capex Consumer Focus expressed further concern about NGET exceeding their opex allowance in '09.

1.7. ***Revenue Drivers:*** Within electricity National Grid and SP agree with rolling forward the revenue driver constants, though National Grid suggests that the base capex should be examined in light of 'connect and manage'. SHETL consider a base capex allowance may be more appropriate than the revenue drivers for a 1 year period. National Grid Gas would like to engage with Ofgem on a case by case basis to agree UCA's (Unit Cost Allowances) if incremental enforcement is required.

1.8. SHETL feel that the incentives under the base case incentives scheme should be paid out in 2012, if it is not possible to complete a full assessment they considered that an appropriate provision should be made in 2012 and trued up in 2013.

1.9. ***Incentives:*** National Grid requested an increase to the 0.5% IFI (Innovation Funding Incentive) allowance.

1.10. ***Parallel activities:*** SHETL and SP expressed a desire for the rollover to be separate from funding allowed through the Enhanced TO incentives work stream. Centrica have requested an investigation of Dynevor Arms LNG storage facility which they state is no longer available yet on which National Grid Gas continues to earn revenue. In addition they would like Ofgem to investigate the issue NGG receiving incentive revenue from the sale of capacity at Fleetwood.

1.11. ***Output measures:*** There is agreement amongst the TOs that the existing Network output measures are rolled over and that license amendments be limited to those required for an adapted rollover - National Grid suggest some housekeeping could also be done on the license.

1.12. ***Calibration:*** SHETL and SP thought an assessment of RoRE is not in proportion with a one year control. All licensees support the use of RoRE analysis for TPCR5, along with increased transparency around the derivation of Cost of Capital and WACC, but the TOs point out its limitations. National grid feel it is an imperfect measure and should be used for directional use only whilst SHETL and SP are concerned that it should reflect transmission specific issues and that it does not reflect financabililty.

1.13. ***Cost of capital:*** All the TOs are against making any modification to the cost of capital. National Grid and SP feel it is not a one year variable and should be based on data forecast over number of years. National Grid also feel, along with SHETL, that the cost of capital should be examined 'in the round' with other factors such as risk/reward, RoRE and financability. SHETL indicate they would not accept the use of the CoC derived in DCPR5 as this was the result of such a holistic assessment. A review is supported by Centrica and EDF Energy with EDF energy suggesting the WACC derived for DPCR5 would be an appropriate value.

1.14. ***Other financial issues:*** There is broad agreement for the proposed treatment of capitalisation, depreciation and tax, though concerns were expressed with the proposed updates to the policy on pensions. National Grid and the trustees of their pension schemes feel that the 15 year deficit recovery period is too long and advocate a 10 year period. The trustees indicate that the longer period would trigger an investigation by the pensions regulator and is likely to lead to a request that the scheme be supported by a contingent asset (e.g. letter of credit) with a significant associated expense that would be passed to the customer. National Grid would also like any under/over allowance from TPCR4 to be granted during the rollover year. EDF Energy feel that any benchmarking between the Transmission companies of pension performance would be compromised due to the small sample set and see no reason why they are not benchmarked against Distribution Companies.

1.15. ***Stakeholder Engagement:*** All TOs emphasise the need for proportionality and would advocate a slimmed down approach to stakeholder engagement. National Grid question the value of a customer challenge group, while SHETL feel the existing charging forum would be an appropriate forum to assess the impact of the rollover of transmission charges. All TOs (along with Centrica Energy) would like to see the publication of timetable showing pinch points with the other regulatory processes running in parallel. Centrica would also welcome consultation on areas of significant change (pensions and finance). To allow adequate time for review Centrica have requested an early publication of the next transmission annual report and early disclosure of information underpinning the consultation documents.

Appendix 4 – Background to RPI-X@20

Introduction

1.1. This Appendix provides more information on the RPI-X@20 project. More information, including recent publications, can be found on the RPI-X@20 pages of the Ofgem website[24].

1.2. Our 'RPI-X@20' review - a major two-year project and a key area of interaction with our work on the rollover – was initiated by Ofgem in March 2008. It is reviewing the workings of the current approach to regulating GB's energy networks and developing recommendations for future policy.

1.3. The conclusions of the RPI-X@20 project will be implemented in the next full price control, TPCR5, on 1 April 2013. However, where there are areas of work we could undertake within the one-year rollover which would smooth the path of TPCR5 but which will be independent of the conclusions from the RPI-X@20 project, we intend to do so.

The rationale underpinning RPI-X@20

1.4. While we recognise that RPI-X regulation has delivered significantly lower prices, better service quality and better network reliability since its implementation, we think that it is prudent to undertake a review now for a number of reasons. First, as a matter of good housekeeping, it is right that after 20 years we assess whether the approach remains fit for purpose. Second, the challenges faced by the energy industry have changed, with the emphasis now on facilitating efficient investment to achieve environmental targets and ensure security of supply as well as on the achievement of efficiency gains. Finally, over time RPI-X has become more complex and, if possible, it may be beneficial to simplify the framework to allow customers and companies to effectively engage in price control processes.

Guiding principles for RPI-X@20

1.5. We don't intend to implement change for changes sake and amendments to the current regime will only be made where there are clear benefits. There are a number of further guiding principles which we are following as part of the RPI-X@20 project including:

- **Consultation:** We are consulting widely with stakeholders through a range of forums including stakeholder workshops, meetings and formal consultation documents. Also through other methods such as the web forum we have developed which provides stakeholders with the opportunity to post papers or thoughts regarding the RPI-X@20 project on the Ofgem website and through

[24] http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx

the working groups that were established. The use of this range of consultative tools allows stakeholders many opportunities to engage in and contribute to the overall review.

- **Transparency:** We are being transparent in the way we undertake this project and will continue to do so in the way we arrive at conclusions and recommendations. Our consultative approach should help to facilitate this.

- **Better Regulation:** We are following a process and intend our conclusions to be consistent with the Better Regulation principles

- **No surprises:** We are adopting a transparent approach to the RPI-X@20 project to ensure that stakeholders are aware of the direction of Ofgem's thinking and the rationale that will underpin the recommendations that we take to the Authority. There should not therefore be any surprises for stakeholders.

- **No retrospective action:** We understand the importance of maintaining regulatory certainty and therefore are keen to make clear that the RPI-X@20 project will be focussed upon the framework for future regulation of energy networks rather than reconsideration of any decisions taken in the past.

- **No stranding of efficient investment:** Where efficient investment has been undertaken by network companies, suitable funding arrangements will be incorporated within any framework that may be adopted following the recommendations of the review.

Progress of RPI-X@20

1.6. We published our 'Principles, Process and Issues' consultation paper in February 2009. Since then we have published a number of working papers in different policy areas designed to inform on our early thinking and provoke debate. We have also published a number of consultant reports and other materials. We will continue to engage with stakeholders and interested parties as our thinking progresses. Our final recommendations will be made to GEMA in summer 2010 and a decision consulted on in Autumn 2010.

Emerging Thinking

1.7. The Emerging Thinking, published in January 2010, document set out our intention to design a new regulatory process for price control reviews that is more streamlined, accessible and transparent. The proposed new regulatory framework would encourage network companies to focus on the longer term and:

- Play a much greater role in facilitating the delivery of a sustainable energy sector whilst continuing to facilitate competition;
- Deliver continuous, long-term improvements in outputs and efficiency;
- Take more responsibility for developing solutions that are best value for present and future consumers;
- Manage uncertainty, taking on risk where appropriate and keeping options open where cost effective;
- Engage more effectively with all stakeholders, responding to existing and anticipated needs of consumers of network services; and
- Be more innovative, looking for new and better ways of delivering and adapting over time as they learn what works best.

Appendix 5 – The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.[25] Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This appendix must be read accordingly.[26]

1.4. The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes;
- the generation, transmission, distribution or supply of electricity;
- the provision or use of electricity interconnectors.

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote competition) in which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must have regard to:

25 Entitled "Gas Supply" and "Electricity Supply" respectively.
26 However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[27]; and
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[28]

1.9. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed[29] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply,

  and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the

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27 Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.
28 The Authority may have regard to other descriptions of consumers.
29 Or persons authorised by exemptions to carry on any activity.

legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[30] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

30 Council Regulation (EC) 1/2003.

Appendix 6 - Glossary

B

Baseline

Baselines define the reference levels of capacity that the gas transmission licensee is to release. Baselines also determine the levels above (or below) which incremental capacity is defined.

Baseline Capital Expenditure

Baseline capital expenditure is the total amount of capex required in association with the baseline. It includes both load related capex and non-related capex.

British Electricity Trading and Transmission Arrangements (BETTA)

BETTA introduced a single GB-wide set of arrangements for trading energy and for access to and use of the electricity transmission system which came fully into effect at BETTA go-live (1 April 2005).

Buy Back

NGG NTS in operating the NTS may find itself in a position where it expects it cannot deliver firm NTS entry capacity that it has previously sold at the various auctions, for example when there are temporary physical constraints on the NTS. In this situation it may buy some of the NTS entry capacity back that it has previously sold in order to meet its obligations, this is known as buy back.

C

Capital Expenditure (capex)

Expenditure on investment in long-lived transmission assets, such as gas pipelines or electricity overhead lines.

D

Distribution Price Control Review (DPCR5)

The price control review for the electricity distribution network operators. The resulting price control covers the years 2010 to 2015.

Distribution Network Operators (DNOs)

Holders of electricity distribution licences. Licences are granted for specified geographical areas. Currently in Great Britain there are seven companies who own the fourteen licensed distribution areas.

F

Forecast Business Plan Questionnaire (FBPQ)

Expenditure information requested by Ofgem from the licensees relating to the period from 20012/13.

G

Gas Distribution Networks (GDNs)

Gas Distribution Networks, of which there are eight, four of which are owned by National Grid Gas plc, and four of which were sold by Transco plc (now National Grid Gas plc) on 1 June 2005 and are now owned by Scotia Gas Networks, Southern Networks, Northern Gas Networks and Wales and West Utilities.

Gas Distribution Price Control Review (GDPCR)

The review of the price control applying to gas distribution networks. The latest GDPCR covers the period from 2008 to 2013.

I

Innovation Funding Incentive (IFI)

A mechanism to remunerate research & development expenditure by DNOs.

K

K-factors

Correction factors to account for the under or over-recovery of revenues between years of the price control.

L

Liquefied Natural Gas (LNG)

LNG consists mainly of methane gas liquefied at around -260 degrees Fahrenheit. Cooling and liquefying the gas reduces its volume by 600 times such that a tonne of LNG corresponds to about 1,400 cubic metres of methane in its gaseous state. LNG may be stored or transported by special tanker.

Load Related Capex

The installation of new assets to accommodate changes in the level or pattern of electricity or gas supply and demand.

N

National Electricity Transmission System Operator (NETSO)

See 'System Operator (SO)'.

National Grid Gas (NGG NTS)

The licensed gas transporter responsible for the gas transmission system, and four of the regional gas distribution companies.

National Grid Electricity Transmission (NGET)

The electricity transmission licensee in England & Wales.

National Transmission System (NTS)

The high pressure gas transmission system in Great Britain.

Non-Load Related Capex

The replacement or refurbishment of assets which are either at the end of their useful life due to their age or condition, or need to be replaced on safety or environmental grounds.

O

Operating Expenditure (Opex)

The costs of the day to day operation of the network such as staff costs, repairs and maintenance expenditures, and overhead.

Operating Margin (OM)

In relation to gas the OM is gas in storage which is reserved by the NTS to ensure the supply of gas is maintained in the event of a network emergency.

R

Regulatory Asset Value (RAV)

The value ascribed by Ofgem to the capital employed in the licensee's regulated transmission or (as the case may be) distribution business (the 'regulated asset base').

RPI-X

The form of price control currently applied to network monopolies. Each company is given a revenue allowance in the first year of each control period. The price control then specifies that in each subsequent year the allowance will reduce by 'X' per cent in real terms.

Re-openers

A process undertaken by Ofgem to re-set the revenue allowances (or the parameters that give rise to revenue allowances) under a price control before the scheduled next formal review date for the relevant price control.

Revenue Driver

A means of linking revenue allowances under a price control to specific measurable events which are considered to influence costs. An example might be to allow a specified additional revenue allowance for each MW of new generation connecting to the network. Revenue drivers are used by Ofgem to increase the accuracy of the revenue allowances.

S

Safety net

A mechanism that would trigger a review of allowances in the event of a major shortfall of investment relative to allowances.

Security and Quality of Supply Standard (SQSS)

As referred to in the electricity Transmission Licence Standard Conditions C17 and D3, this is the standard in accordance with which the electricity transmission licensees shall plan, develop and operate the transmission system.

Scottish Hydro-Electric Transmission Limited (SHETL)

The electricity transmission licensee in northern Scotland.

Scottish Power Transmission Limited (SPTL)

The electricity transmission licensee in southern Scotland.

Sliding scale

This term is used generically to describe incentive schemes which involve profit (and loss) sharing around a fixed target costs, such as the current form of SO incentives in gas and electricity.

Sulphur Hexafluoride (SF6)

A potent greenhouse gas frequently used in electrical equipment.

System Operator (SO)

The system operator has responsibility to construct, maintain and operate the NTS and associated equipment in an economic, efficient and co-ordinated manner. In its role as SO, NGG NTS is responsible for ensuring the day-to-day operation of the transmission system.

T

Total Cost Allowance (TCA)

Is the Unit Cost Allowance multiplied by the number of units.

Transmission Connected Customer (TCC)

A customer directly connected to the gas or electricity transmission system.

Transmission Entry Capacity (TEC)

Defines a generator's maximum allowed export capacity onto the transmission system. The holder of the TEC has the right to export the specified number of megawatts onto the transmission system at any one time, and is eligible for compensation if NGET cannot accommodate this export on the network.

Transmission Investment for Renewable Generation (TIRG)

The regulatory mechanisms developed before the start of TPCR4, to fund a number of specific network enhancement projects required to provide transmission capacity for new renewable generation plants.

Transmission Owners (TO)

Companies which hold transmission owner licenses. Currently there are three electricity TOs; NGET, SPTL and SHETL. NGG NTS is the gas TO.

Transmission Price Control Review (TPCR)

The TPCR will establish the price controls for the transmission licensees which will take effect in April 2007 for a 5-year period. The review applies to the three electricity transmission licensees, NGET, SPTL, SHETL and to the licensed gas transporter responsible for the gas transmission system, NGG NTS

True up

This is the adjustment for the difference between the allowance and the actual expenditure in the previous price control.

U

Uniform Network Code (UNC)

As of 1 May 2005, the UNC replaced NGG NTS's network code as the contractual framework for the NTS, GDNs and system users.

V

Vesting Assets

Assets included in the RAV at the vesting date.

Vesting

The date at which the regulated gas and electricity transmission and distribution companies were privatised.

Vanilla Weighted Average Cost of Capital (Vanilla WACC)

The weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity.

W

Weighted Average Cost of Capital (WACC)

The weighted average of the expected cost of equity and the expected cost of debt.

Appendix 7 - Feedback questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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