Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ

David Hunt
Transmission and Governance Team
The Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Tel: 01738 456400
Fax: 01738 456415

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Dear David

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

We welcome the opportunity to respond to the above decision and consultation paper and hope that you will find the following comments useful.

We agree with Ofgem's objectives of proportionality and therefore, in the main, the approach that Ofgem has adopted for the rollover. However, in addition to responding to the specific questions that Ofgem asked in this consultation, we do have some specific comments which we have set out below.

Qu 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?

The original intent of the capex revenue driver was to manage the uncertainty associated with the volume of new generation seeking to connect to the network within the TPCR4 price control period. However, for the rollover year, and for SHETL at least, there is not the same level of uncertainty given the timings involved. In our view, any uncertainty regarding the forecast capex for 2012-13 would be adequately addressed via the "normal" capex efficiency incentive thereby negating the need for a specific revenue driver. Accordingly, we do not support the continuation of the revenue driver for the rollover year.

We would also note that the nature of the revenue driver is such that its application to the rollover year would necessarily make the next price control more complex. This is because the nature of the existing revenue driver mechanism includes a time-lag between the networks incurring costs and the incentive mechanism allowing their recovery, meaning that an assessment and "true-up" of performance under the incentive for the rollover year would necessarily need to take place in the next price control period. This further supports our view that it is not appropriate to extend the revenue driver in the rollover year for SHETL. However, this would not necessarily preclude a different approach being taken for National Grid if that was deemed appropriate on the grounds that a different approach to revenue drivers has already been taken in TPCR4.

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

Although SHETL has not yet "triggered" the application of the SF6 incentive, it is our intention to do so. SSE has undertaken significant work on the SF6 methodology to meet the requirements of European regulations introduced in April 2010 and we anticipate being in a position to progress the incentive with Ofgem in the near future. Notwithstanding SHETL's position in this respect, we support the continuation of the existing SF6 incentive for the rollover year. It is a relatively simple incentive to extend for a further year and to do so would, in our view, be consistent with wider environmental initiatives. However, our support for this is based upon the extension of the existing mechanism - leaving any wider review (or change to the mechanism) to be considered under the environmental outputs work being undertaken as part of TPCR5.

Qu 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?

We strongly believe that NGG should deliver capacity in a timely manner given the consequence of late delivery for a Users' investment, and since those booking capacity have to do so in advance as well as provide a user commitment. We therefore agree that the incentive should continue for the rollover year and, consistent with Ofgem's view of proportionality, it would seem appropriate to do so in its current form. We also believe that any further enhancement of this incentive should be taken forward as part of the TPCR5 outputs work.

Qu 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)?

We agree that this would seem to be a consistent and proportionate approach for Ofgem to adopt.

Turning now to other points we would like to raise.

(i) Capex.

We fully support Ofgem's decision to progress and manage separately the work that will continue on the enhanced TO incentives to set allowances for 2011-12 and 2012–13. However, as with the approach adopted in the current control, it will be important to include "pre-preconstruction" allowances for future enhanced TO incentive capex in the rollover base capex allowances.

While we support Ofgem's proposal to undertake a proportionate review of the forecast capex information provided by the TOs, we would be concerned if, in doing this, Ofgem adopted an average unit cost approach as it did in DPCR5. As per our discussions with Ofgem on the draft FPBQ for the rollover year, we firmly believe that the small number of schemes being considered and the "bespoke" nature of such jobs do not lend themselves to this type of analysis. We therefore believe that it would be more appropriate for Ofgem to review a sample of schemes to better understand the TOs' forecasts and consider actual expenditure further as part of Ofgem's comprehensive historic assessment of TPCR4 capex for TPCR5.

While we understand that Ofgem will set the opening RAV for 2012-13 on an indicative basis and based upon all capex incurred in TPCR4, no mention has been made of its intention to true-up the capex incentive that has applied to TPCR4. We therefore believe that in setting the opening RAV for the rollover year, Ofgem's assessment should take account of the TOs' performance under the incentive. To the extent that the final position cannot be determined until a full assessment of the historic expenditure has taken place, a final further adjustment could be made in 2013.

We are disappointed that Ofgem has decided to exclude the addition of logged-up costs (and by implication, expenditure associated with securing critical network infrastructure) until the completion of its historic expenditure review. As Ofgem has stated, the provisional opening RAV should include *all* capex incurred during TPCR4 and this should, therefore, include these two specific areas of additional expenditure. At the very least, we firmly believe that Ofgem should include in the rollover opening RAV expenditure associated with securing critical network infrastructure. This has been separately audited and, therefore, its inclusion in the rollover opening RAV is not an issue nor would we expect Ofgem to include this expenditure in the subsequent full historic review of expenditure as part of TPCR5.

(ii) Financial Issues

We note that Ofgem's decision paper makes no explicit reference to financeability. Whilst we recognise that this is one of the key aspects of Ofgem's RPI-X@20 review where Ofgem's recommendations will apply from April 2013 there is, however, a specific need to consider this in the context of the rollover year particularly since SHETL's pre-vesting assets are fully depreciated in March 2012 and the scale of SHETL's investment programme.

Ofgem has stated that any update of the allowed rate of return following its high level review of all of the inputs into the cost of capital would also apply to capex funding under the enhanced TO incentive regime. Whilst we understand that this is consistent with Ofgem's previously stated approach for TO capex, given the magnitude of the capex, it will be essential to ensure that Ofgem's final proposals for the allowed rate of return does not cause unacceptable financeabililty issues for the network companies. In respect of the TIRG projects, the funding mechanism has already been set out in the licence and should not be modified. It allows for future consideration of the return on these projects for post construction price control years 6 –

20 and therefore it will be essential to ensure that such consideration is taken in the wider financeability context of the business.

We hope that you fill find these comments helpful.

Yours sincerely

Rob McDonald
Director of Regulation