



Company Secretary
SP Transmission Limited
New Alderston House
Dove Wynd
Strathclyde Business Park
Bellshill
ML4 3FF

*Promoting choice and
value for all customers*

Direct Dial: 020 7901 7009
Email: stuart.cook@ofgem.gov.uk

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Dear Company Secretary

Approval of statement pursuant to special condition J10 (Basis of transmission owner charges) of SP Transmission Limited's electricity transmission licence.

This letter sets out the Authority's decision to approve the revisions contained in the statement set out in a separate Annex to this letter pursuant to special condition J10 (Basis of transmission owner charges) ("SC J10") of SP Transmissions Limited's ("SPTL") electricity transmission licence.

Background

Under its electricity transmission licence, SPTL is required to have a statement, approved by the Authority, setting out the basis upon which it will charge National Grid Electricity Transmission plc ("NGET") for the services provided. The services comprise:

- Transmission owner services;
- Connections to the licensee's transmission system; and
- Outage charges.

Pursuant to SC J10, SPTL shall, at least once in every year, make necessary revisions to the statement in order that the information set out in the statement shall continue to be accurate in all material respects.

SPTL submitted its revised Statement of the Basis of Transmission Owner Charges for approval by the Authority on 6 April 2010. We published this statement on 4 May 2010¹ and invited wider views on the proposed revisions by 2 June 2010.

Subsequent to the publication of our statutory consultation a minor omission in the explanatory text of the revised draft statement submitted by SPTL on 6 April 2010 was identified. Taking into account the need for transparency in our processes, SPTL submitted an updated statement on 26 May 2010 and a further revised statement on 9 July 2010. Given the minor nature and scope of the revision we decided not to withdraw or restart the statutory consultation.

SPTL's proposed revisions

¹ Consultation available on Ofgem website:
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=141&refer=Networks/Trans/ElecTransPolicy/Charging>

The revisions SPTL proposed comprise changes of a housekeeping nature, and specific structural and content changes to achieve better consistency with developments in NGET's Statement of Use of System Charges effective from 1 April 2010.

In terms of the housekeeping changes, the proposed revisions largely reflect additional explanatory text to the Transmission Owner Revenue Restriction formula, as set out in special condition J2 ("SC J2") of SPTL's transmission licence, and to SPTL's description of the General System Charge and Site Specific Charges.

The revision to the text of the SC J2 formula is intended to reflect the recent modification to special condition J12 of SPTL's transmission licence associated with the development of enhanced transmission investment incentives and the introduction of a provision in SPTL's TO revenue formula to allow recovery of certain pre-construction and construction costs associated with specific transmission reinforcement projects for the period until 31 March 2012.²

The revisions to SPTL's explanatory text have been proposed as a result of SPTL's review to ensure greater consistency with the connection charging methodology of NGET. This process was instigated at Ofgem's request as part of the approval process of SPTL's 2009/10 charging statement to address a difference in interpretation between NGET and SPTL identified during the course of 2009.³ The result is that the explanatory text proposed by SPTL (in the sections entitled 'Principles' and 'Transmission Owner Revenue Restriction' and also in 'Part 1' of the statement) has been revised.

In terms of the specific changes, we note the revisions SPTL proposed to Part 3 of the draft statement. These changes reflect the new structure proposed under NGET's recently concluded Application Fees consultation⁴ and reflected in the text contained within Schedule 2 of NGET's Statement of Use of System Charges effective from 1 April 2010. In particular, we note additional explanatory text in Part 3 describing the purpose and rationale of application fees, revision to the Transmission Licensees' Boundaries of Influence Map in appendix 2 of SPTL's statement to reflect the new application fee structure. The proposed appendix 2 changes include a reduction in the number of applicable zones from six to three, and a significant revision to the range of application fee figures contained in Tables A and B as well as the addition of two new tables (C and D).

Finally, we note that SPTL made small revisions to the following areas:

- The indicative connection asset charges contained in appendix 1, decreasing the unit charge for 132kV transformer cables.
- The presentational order of the algebraic method by which SPTL will calculate the annual charges where NGET elects to pay all or part of the actual installation costs over a period of up to 40 years ('option 1: annual charges, out turn price'); and
- The explanatory text to describe the civil engineering costs of connection sites (page 16) to ensure the correct allocation of costs and to ensure its statement is consistent with NGET's connection charging methodology.

Respondents' views

We received one response to the consultation. This was submitted by NGET and was not marked confidential⁵. NGET made two specific comments in relation to the text of SPTL's proposed statement:

² The modification was given effect through a Notice published on 31 March 2010, available from the Ofgem website.

³ As set out in our letter approving the revisions to SPTL's 2009/10 statement published on 25 June 2009, available from the Ofgem website.

⁴ NGET published an "Open Letter to Industry on proposals to restructure application fee tables" published on 16 November 2009. NGET published a 'Response to Open Letter' on 22 February 2010.

⁵ This letter can be found via the link provided in footnote 1.

- NGET supported the revised draft version of SPTL's statement which included reference to the capital costs for pre-Vesting transmission connection assets within the explanatory text of SPTL's General System Charge; and
- NGET proposed that further amendment to SPTL's text was necessary in order to provide clarification of the principles under which the maintenance costs of post-Vesting assets are recovered by SPTL.

NGET's response made a further general point on the reproduction of the text of the connection charging methodology of NGET within both Scottish licensee statements. NGET agreed with the proposed inclusion of this text but consider that its inclusion now makes it necessary to confirm the interpretation of these clauses with the aim of ensuring a common understanding on the connection charging boundary. NGET noted that it had circulated its position and relevant understanding on the appropriate clauses and on the connection boundary and charging implications to SPTL and SHETL in December 2009 and is currently awaiting comment and confirmation from both.

Ofgem response to respondent's views

Capital costs of pre-Vesting transmission connection assets

We note NGET's support for the reinstatement of the reference to the capital costs for pre-vesting transmission connection assets within SPTL's statement describing its General System Charge which is set to recover the allowed TO revenue (TO_t) as set out in formula contained in SC J2 of SPT's transmission licence.

However, we note that the updated draft statement submitted by SPTL on 26 May 2010 contains an explanation of General System Charge that makes reference to "*the capital costs for SPT's pre-Vesting connections*" only; suggesting that capital charges for replacement/refurbishment of pre-vesting connection assets will not be recovered through SPTL's General System Charge.

We note that the capital costs for replacement/refurbishment of pre-vesting transmission connection assets were included in the approved explanatory for General System Charges as part of SPTL's 2009/10 statement.

We sought further clarification from SPTL on the treatment of replacement and/or refurbishment of pre-Vesting transmission connection assets. In response, SPTL confirmed that the proposed revisions intend to align with the arrangements applied by NGET. With that approach in mind, SPTL agreed that the proposed revisions are intended to clarify that the capital costs associated with the replacement and/or refurbishment of SPTL's pre-Vesting transmission connection assets will continue to be recovered through the General System Charge. SPTL agreed to revise the text to make this clear. SPTL submitted a further revised statement on 9 July 2010.

In addition, SPTL explained that the capital and operation and maintenance ("O&M") costs associated with original (i.e. pre-Vesting) transmission connection assets will continue to be recovered under the General System Charge, and be included in SPTL's allowed revenue allowance (TO_t), until the asset has been fully depreciated. After this point, the asset will become a 'new' post-Vesting transmission connection asset and the capital costs of the 'new' transmission connection asset will be treated as an Excluded Services Charge. SPTL explained that the O&M costs associated with the 'new' transmission connection asset will be recovered under the EXS_t term in accordance with special condition J8 of SPTL's licence. SPTL agreed to modify the explanatory text of the statement to provide clarity on this point. SPTL submitted a further revised statement on 9 July 2010, set out in a separate Annex to this letter.

Harmonisation of licence interpretation

We note NGET's concerns over the cost allocation of asset costs. We are also aware that there have been discussions at meetings of the Charging Users Group ("ChUG") which have taken place to try to improve the general understanding of such cost allocations and develop a common charging approach between SPTL and NGET.

Despite the discussions at ChUG, it is clear from NGET's response that there remains some confusion as to the level of understanding achieved.

Through our attendance of the ChUG we recently sought further clarification from SPTL on the issue of a common charging approach between SPTL and NGET, in particular the comment in response to our industry consultation from NGET.

In response, SPTL explained that, when setting charges for SPTL, the capital costs associated with 'new' transmission connection assets for new users built since 1990 (i.e. post-Vesting) are currently treated as Excluded Services income and are recovered through Site Specific Charges, while the annual capital costs associated with any connection site (i.e. pre-Vesting or post-Vesting) which has undergone asset replacement or refurbishment are recovered through the General System Charge (TO_t)⁶. SPTL proposes to apply a retrospective change to its charging approach and to implement a new charging approach between SPTL and NGET from 1 April 2010.

In simple terms, the proposed charging approach involves SPTL extending the scope of annual Site Specific Charges for Excluded Services to cover a wider spread of transmission connection assets than currently applied by SPTL. In practical terms, the proposed revision to SPTL's charging approach is that SPTL's TO Site Specific Charges will no longer recover only the capital costs of 'new' post-Vesting transmission connection assets for new users (paying annual charges) but instead be expanded to include the annual capital costs for all post-Vesting transmission connection assets, including the capital costs associated with refurbishment and/or replacement such assets. In addition, SPTL proposes that the EXS_t term, as set out in J8 of the licence, recovers the O&M costs associated with the above post-Vesting transmission connection asset categories.⁷

The impact of this adjustment in SPTL's approach will result in SPTL making an adjustment to the revenue recovered through the current definition of General System Charge such that total revenue recovered remains equal to the revenue recovered from the charging approach consistent with SPTL's current price control arrangements.

We note SPTL's explanation that the difference in the split of the TO charges to NGET will not impact the Use of System or Connection charges levied by NGET on users of the transmission system as NGET sets charges to ensure that all Users are charged on a consistent basis across Great Britain.

While welcome this additional explanation, we are of the opinion that the fundamental requirement to provide consistency and clarity to users of the system is paramount. We consider that the situation that currently exists is far from ideal and further highlights that, wherever possible and appropriate, consistency in TO treatment of costs and their allocation should be aimed for. As such we look to SPTL, SHETL and NGET to work to improve the consistency between their respective approaches, with the aim of reducing the possibilities for future mismatches in revenue and in the charging approach applied.

In terms of the next steps in the process, this work should be undertaken over the forthcoming year and any changes or points of clarification should be made for inclusion in the charging statement for charging year 2010/11.

⁶ For the avoidance of doubt, in addition to these categories SPTL's current charging approach also recovers all infrastructure capital costs, existing pre-Vesting connection annual capital costs and the O&M costs associated with all the relevant categories through the General System Charge.

⁷ For the avoidance of doubt, O&M costs associated with all SPTL's pre and post Vesting infrastructure assets and pre-Vesting connection assets, including replacement and /or refurbishment, will continue to be recovered under the General System Charge.

Application fees

We note that the proposed changes reflect the new structure proposed under NGET's recently concluded Application Fees consultation and reflected in the text contained within Schedule 2 of NGET's Statement of Use of System Charges effective from 1 April 2010.

Connection charging boundary

We note that further to its response to our consultation, NGET raised this issue at the June 2010 ChUG meeting and that all parties agreed in principle with the need to jointly agree and confirm the interpretation of these clauses with the aim of ensuring a common understanding on the connection charging boundary when dealing with user queries and connection applications.

We note that the issue raised by NGET relates to the desire to have an agreed prescriptive approach that encompasses all charging boundary definition examples across each of the three transmission areas to completely remove the risk of any possible misunderstanding when dealing with customer queries. As such we consider this issue to be outside the scope of our approval obligation. However, we expect this issue to be progressed through the ChUG process in the near future and for any potential differences identified to be addressed by the three transmission licensees in a common approach that is consistent with their statutory and licence obligations and with NGET's connection charging methodology.

Furthermore, we acknowledge that NGET, SHETL, and SPTL have committed to work together and arrive at a common charging approach for the start of the next price control period. In the meantime we recognise that discussion has been ongoing through ChuG to create greater consistency between the statements, and there has been ongoing discussion in that context of the potential to harmonise the three existing statements and produce one statement (subject to appropriate licence changes being implemented). We expect NGET, SHETL and SPTL to continue to consider the potential for such harmonisation.

Authority's decision

We have considered whether the revisions contained in the statement submitted by SPTL are consistent with the requirements of SC J10 and SPTL's wider licence and statutory obligations. Notwithstanding the potential for further changes to be proposed, on balance, the Authority is content that the revised statement is consistent with these obligations. Similarly, the Authority has had regard to its principal objective and general duties in considering the draft statement and is content that approval of the revisions in the statement is consistent with these.

Pursuant to paragraph 6 of SC J10 of SPTL's electricity transmission licence, the Authority hereby approves the revisions contained in the Statement of the Basis of Transmission Owner Charges set out in a separate Annex to this letter.

Yours sincerely,



Stuart Cook
Senior Partner, Smarter Grids & Governance
Duly authorised on behalf of the Authority