Gareth Walsh
Smarter Grids & Governance Team
Ofgem
9 Millbank
London
SW1P 3GE

13 May 2011

Dear Gareth

TPCR4 Rollover Policy Update and Initial Analysis of Business Plans

EDF Energy is one of the UK's largest energy companies. We provide 50% of the UK's low carbon generation. Our interests include nuclear, coal and gas-fired electricity generation, renewables, combined heat and power plants, and energy supply to end users. We have over 5 million electricity and gas customer accounts in the UK, including both residential and business users.

We welcome the opportunity to respond to this consultation and have provided detailed answers to your specific questions as an attachment to this letter. The key points of our response are:

- As the GB electricity industry seeks to decarbonise in a secure and affordable manner, it is important that the TPCR4 roll over year provides appropriate funding to the electricity Transmission Owners (TOs). This will ultimately benefit consumers by facilitating the timely and efficient connection of low carbon generation.
- The gas system is facing a significant period of uncertainty during this time. However, there has been no evidence presented to date which might warrant a significant increase in NGG's allowed revenue either in the TPCR4 roll over year or for the beginning of the RIIO-T1 period.
- The capex incentive for NGET should be approved on a provisional basis with a full review at RIIO-T1. This is consistent with Ofgem's proposed treatment of the other TOs and is aligned with the expectations for this incentive when it was set.
- The significant increase in non-operational capex forecast by National Grid (NG) does not appear warranted for either the electricity or gas systems. We believe further analysis and scrutiny is required in this area.
- Ofgem appear to be taking a generous approach to the TOs when setting cost of equity and debt. Given the fundamental change in the financial markets and economy since the TPCR4 was set there might be sufficient evidence to review and reduce both of these parameters.

Ofgem appears to have taken a balanced approach when setting the policies intended to be employed in the TPCR4 roll over. As this is only a one year roll over the uncertainties

EDF Energy
Cardinal Place, 80 Victoria Street,
Victoria
London SW1E 5JL
Tel +44 (0) 20 3126 2312

regarding generation connection and capex requirements are significantly reduced, compared with forecasting such requirements five years in advance. It would therefore seem appropriate to remove the logging up mechanisms, while retaining the revenue drivers to recognise that some uncertainties remain regarding the development, consenting and connection of a number of generating stations.

Recently, Ofgem has decided to not allow the Income Adjusting Event (IAE) raised by Centrica with regards to the Fleetwood entry point. We believe that the TPCR4 roll over represents the first opportunity to address this issue and avoid NGG earning abnormal profits with limited risk exposure. We are particularly concerned as the KEMA report into NGG's capex requirements has indicated that NGG is seeking to claim for significant costs which might already have been funded by consumers through previous price controls.

I hope you find these comments useful, however please contact my colleague Stefan Leedham (**Stefan.leedham@edfenergy.com**, 020 3126 2312) if you wish to discuss this response further.

Yours sincerely

Rob Rome
Head of Transmission and Trading Arrangements
Corporate Policy and Regulation

Attachment

TPCR4 Rollover Policy Update and Initial Analysis of Business Plans

EDF Energy's response to your questions

<u>CHAPTER: Two</u>

Question 1 : Do stakeholders agree with our view that it is not necessary to allow any cost categories to log-up during the TPCR4 rollover year, but for forecasts to be included in the base allowances?

The logging up mechanism was designed to cover TO expenditure towards the end of the TPCR4 period that was uncertain due to the relatively long lead times associated with this expenditure. This uncertainty is not present with the TPCR4 roll over year as it is relatively close. We therefore concur with Ofgem that a logging up mechanism is not required for the TPCR4 roll over year.

Question 2: Do stakeholders agree that it is appropriate to continue to pass through the current set of pass-through costs to consumers?

This appears reasonable as the costs are outside of the TOs' control.

Question 3: Do stakeholders agree that it is appropriate to make TO/SO adjustments in response to the gas revenue drivers on 31 March 2012 and 31 March 2017?

Ofgem's proposed approach is consistent with the intent of the pre-2007 entry capacity regime and so appears appropriate. However, we are unclear what the intention is behind the post-2007 revenue driver regime. Within the TPCR4 roll over document Ofgem indicate that they intend to keep the revenue drivers unchanged; however, they have also recently consulted suggesting a change to the historic revenue drivers for the Pembroke and Marchwood exit points[1]. We support Ofgem's proposal to keep the revenue driver regime in its current form.

[1] See Ofgem consultation: "Open letter consultation: Setting new revenue drivers, updating existing revenue drivers and adding new exit points to the Gas Transporter Licence" available at: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Consultation_revenue%20drivers_Marchwood%20and%20Pembroke%20(2).pdf&refer=Networks/Trans/GasTransPolicy/RevenueDrivers

Question 4: With respect to Milford Haven do stakeholders agree that it is appropriate to keep the £9.5m (2004-5 prices) downward adjustment to the TO allowed revenue but review the figure?
We do not believe it is appropriate (or in customers interests) for NG to be remunerated through both the TO and SO mechanisms for the Milford Haven investment as this would represent double counting. We therefore support Ofgem's proposal to maintain the downwards adjustment to the TO allowed revenue but to review the level of this adjustment to ensure it remains appropriate.

Question 5: Do stakeholders agree with our view that no new electricity transmission revenue driver need be introduced for the TPCR4 rollover year?
The investment required on the electricity transmission system is significant and it is imperative that it is delivered in a timely and efficient manner. This will support the connection of new and existing generation plant, maintain security of supply and minimise constraint costs, all of which will provide benefits to investors and consumers. We therefore believe that any uncertainty associated with the 1 year roll over should be minimised. There remains sufficient uncertainty with regards to the connection and consenting of some generation plant that it is appropriate to maintain the revenue drivers and we support Ofgem's proposal not to set new revenue drivers.

Question 6: Do stakeholders agree with our start and finish date based approach to determining capex allowances for TPCR4 revenue driver projects during the TPCR4 rollover year?
This approach appears reasonable and ensures that funding is available in the TPCR4 roll over year for projects that have already commenced.

Question 7: Do stakeholders agree with our proposal to maintain the capex incentive in the TPCR4 rollover year and keep the sharing factor unchanged at 25%?
This appears appropriate for a one year price control and ensures that the TOs remain incentivised to incur capex spend efficiently.

Question 8: Do stakeholders agree with our proposal to allow the capex incentive payment on a provisional basis for SPTL, SHETL and NGG, making any further adjustments as part of the RIIO price control?
This seems reasonable and commensurate with a one year price control.

Question 9: Do stakeholders agree with our proposal to defer payment of NGET's capex incentive until we have performed a detailed assessment of projects regarded as WIP, and fully considered the impact of connect and manage and TO incentives?

We are concerned with the different treatment of NGET with regards to the capex incentive. As recognised by Ofgem, the level of investment required by NGET to connect generation while minimising constraints across boundaries is significant. These investments will have been made at the start of the price control period with an expectation that they would have been subject to a capex incentive in 2012. We are concerned that delaying the application of a capex incentive for NGET might introduce a perceived increase in regulatory risk for NGET and may have a detrimental impact on the delivery of investment in the short term. The costs to consumers of delaying this investment could result in higher constraint costs which would outweigh any savings associated with delaying a provisional payment of the capex incentive for a full review in 2013. We therefore believe that NGET should be allowed the capex incentive on a provisional basis as is being proposed for SPTL, SHETL and NGG.

Question 10: Do stakeholders agree with our proposal to maintain the SO capex incentive for National Grid in their role as gas and electricity SO for the TPCR4 rollover year and keep the sharing factor set to ±25%? Do stakeholders also agree with our proposed approach to make a provisional revenue adjustment in 2012-13 in line with the SO capex incentive, and true this up as part of the TPCR4 rollover?

This seems reasonable and commensurate with a one year price control.

Question 11: Do stakeholders agree with our proposal to maintain the gas internal SO opex sharing factor at ±40%, and align the electricity SO internal sharing factor with that used for incentivising external costs?

This seems reasonable and commensurate with a one year price control.

Question 12: Do stakeholders agree with our proposed approach to leave the electricity reliability incentive scheme and its parameters unchanged for the TPCR4 rollover year?

This seems reasonable and commensurate with a one year price control.

Question 13: Do stakeholders agree with our provisionally preferred approach to continuing to incentivise a reduction in the leakage rate of SF6 gas, updating the target leakage rates to reflect performance during TPCR4?

This seems reasonable and commensurate with a one year price control.

Question 14: Do stakeholders agree that it would be appropriate to maintain the default investment lead times for NGG at their current length?
The intent of the Planning Act 2008 was to speed up the planning process for delivering nationally significant infrastructure including transmission assets. This represents a change from the traditional planning process, but we are not convinced that this would result in a longer planning process for NGG's assets. We therefore concur with Ofgem that it is appropriate to retain the current default lead times in NGG's Licence, with the expectation that there is a fundamental review during the RIIO-T1 process.

Question 15: Do stakeholders agree that it would be appropriate to give NGG the permit scheme payout in 2012-13 and extend the permit scheme for one year by pro-rating existing parameters?
This seems reasonable and commensurate with a one year price control.

<u>CHAPTER: Three</u>

Question 1: Are the forecasts put forward by the transmission companies reasonable given the significant increase over 2011-12 allowances and historical costs?
The electricity market in GB is undergoing a period of significant change with a large amount of intermittent generation connecting at the periphery of the system, and existing plant reaching the end of its economic life, all impacting on the flows that the transmission system has to accommodate. As identified by the ENSG, this will require an unprecedented level of investment in the electricity system. The forecasts put forward by the electricity transmission companies therefore appear reasonable although there is an expectation that this might be slightly higher than what will be allowed as part of the negotiation process.

However, the pressures facing the electricity market are reversed for the gas market. At a time of increased electricity generation and demand it is expected that the GB's gas demand will remain flat in the near future and decline in the long term. Although supply flows in GB may change as traditional gas sources reach the end of their economic life, there remains spare capacity in the GB transmission system as demand is reducing. This compares to a constrained electricity system in comparison with investment required to remove these constraints. We therefore do not believe that the forecasts put forward by NGG are reasonable, and that an allowance in line with the 2011/12 figures would in fact represent a generous allowance for NGG.

Question 2: Do you agree with our consultants' assessment of the TOs' forecasts?
We have reviewed the KEMA reports into the TOs' forecasts and these appear to represent a thorough and extensive review of the elements they have been asked to investigate. We therefore agree with the consultants' assessments.

Question 3: Do you agree with our proposed "next steps" set out in this chapter?
This seems reasonable and commensurate with a one year price control.

Question 4: Do you consider there is a case for investment in network flexibility by NGG in 2012-13?
The issue of network flexibility has been discussed extensively as part of NGG's stakeholder engagement as part of the RIIO-T1 mechanism. Throughout these discussions Shippers have been sceptical as to whether the level of flexibility that NGG is forecasting will ever be achieved. There has been recognition that there is uncertainty in this area regarding future flows and patterns, but there has been little evidence presented that this is an issue now or in the near future. The current flows experienced on the NTS have come as no surprise with NG, Ofgem and industry all forecasting these new supplies as far back as 2005/06. At the same time, these new flows and entry points have all been accompanied by entry capacity signals, user commitment tests and revenue drivers. We remain to be convinced that there is any need for investment in 2012-13 for network flexibility, and note that if there is any need then this would appear to already have been funded by previous price control allowances and revenue drivers.

CHAPTER: Four

Question 1: Are the forecasts put forward by the TOs reasonable given the significant increase over 2011-12 allowances?
The forecasts put forward by NGG, NGET and SPTL for opex costs appear reasonable and relatively in line with allowances throughout the TPCR4 period; however, in light of this stability the increase forecast by SHETL appears excessive. Although we recognise that the capex requirements of SHETL are increasing significantly, resulting in an increased opex requirement; we also note that SPTL faces the same pressures but is forecasting a relatively stable opex requirement.

However, the forecasts put forward by NGET and NGG for non-operational capex appear high, particularly that put forward by NGG which represents an increase of almost 100% on the 2011/12 allowance. Given the relative stability of the gas market in GB compared to electricity we remain to be convinced that this level of increase is justifiable.

Question 2: Do you agree with our assessment of the TOs' forecasts?
This seems reasonable and commensurate with a one year price control.

Question 3: Should Workforce Renewal and Staff Recruitment be made a separate allowance from the general opex?
The issue of workforce renewal and staff recruitment in the UK is a complex issue, particularly in the energy industry with a potential shortage of suitably skilled

engineers. It is widely recognised that the workforce in the UK is ageing; however this is particularly the case for energy companies and network operators who have a significant portion of their staff base approaching retirement. In this environment companies are competing to attract staff, and so it is important that allowances are sufficient to support this. We note in the consultation Ofgem's concern regarding pay constraint within the wider sector, although we also note that some sectors are benefitting from 10% pay increases over a two year period[2]. We therefore believe that a separate allowance is appropriate for workforce renewal and staff recruitment as it important that network companies are able to attract and retain suitably qualified and knowledgeable staff in a very competitive environment for these skills.

Question 4: Do you agree with our proposed "next steps"?
This seems reasonable and commensurate with a one year price control.

<u>CHAPTER: Five</u>

Question 1: We are seeking stakeholders' views on whether the available evidence supports leaving the assumed cost of equity unchanged for the TPCR4 rollover year.
The evidence provided in the Europe Economic report for Ofgem supports a change to the cost of equity so that it is set at 6.5%, compared to the 7.0% allowed as part of TPCR4. We also believe that the use of an equity beta less than 1 for DPCR5 suggests that the same figure should be applied in the TPCR4 roll over year.

Question 2: We are seeking stakeholders' views on whether there is sufficient evidence to support updating the assumed cost of debt for the TPCR4 rollover year.
The TPCR4 allowances for debt and equity were set in 2006. Since then there have been radical shifts in the economy and the financial markets as a result of which interest rates and LIBOR rates are at a historical low. These rates are fundamental in setting the cost of debt and so we believe that there is sufficient evidence to update the cost of debt. Further, we believe that the rate suggested by Ofgem and Europe Economics at 2.75% represents a reasonable allowance for this price control year.

Question 3: We are seeking stakeholders' views on whether we should review SHETL's notional gearing for the TPCR4 rollover year.
As previously recognised the level of investment required in the electricity transmission system to support the fundamental shift in GB's generation mix is unprecedented. We therefore believe that there is a value in reviewing the notional gearing level of the TO when appropriate. Given the issues identified by KEMA and Ofgem it would appear appropriate to review SHETL's notional gearing level. We would; however, note that SPTL

[2] http://www.rmt.org.uk/Templates/Internal.asp?NodeID=144534

is also facing similar pressures and so there would appear to be a value in reviewing both SHETL's and SPTL's notional gearing levels.

EDF Energy
May 2011