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For the attention of gas and
electricity licensees and any
other interested parties

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Date: 24 June 2011

Dear Colleagues

Ref: 83/11

Notice of proposed Modification of National Grid's Electricity Transmission Licence and Gas Transporter Licence in respect of its National Transmission System to include an Income Adjustment term relating to the recovery of certain security-related costs under Section 11(3) of the Electricity Act 1989 and Section 23(3) of the Gas Act 1986.

This letter sets out our conclusions on proposed modifications to National Grid's (NG's) National Transmission System (NTS) Electricity Transmission and Gas Transporter licences,¹ to allow recovery of the efficient costs of delivering security works required by Government. It also sets out our statutory consultation on the proposed amendments and contains the necessary Notices under Section 11(3) of the Electricity Act (1989) "the Electricity Act" and section 23(3) of the Gas Act (1986) "the Gas Act".

We consulted on this in 2008². Our 2008 consultation set out our proposal to amend Special Condition D2 "Restriction on Transmission Network Revenue" of NG's Electricity Transmission Licence and our proposal to amend Special Condition C8B ("NTS Transportation owner activity revenue restriction") of NG's Gas Transporter Licence (NTS). In both cases, we proposed to amend the licences to include an income adjustment term relating to the recovery of certain security-related costs.

Background

At the time of the last price control the forecast cost of capital expenditure on security works required by Government was highly uncertain and therefore the price control revenues were set without specific allowances for these. The two National Grid businesses expected to spend around £100m over the five years of the price control (2007 – 2012) improving the robustness of critical national infrastructure on their networks. We agreed that these costs would be "logged up" and assessed and then funded through the next transmission price controls. National Grid would keep a record each year and at the next price control an allowance would be provided including a return on all efficiently incurred expenditure from the date the expenditure was incurred. The costs relate to work that is specified by Government and which are subject to an independent audit.

¹ <http://www.ofgem.gov.uk/Networks/Trans/RegReporting/Documents1/20080806%20Security%20Amendment%20Consultation.pdf>

² http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=20080806_Security_Amendment_Consultation.pdf&refer=Networks/Trans/RegReporting

Since the last price control was agreed the volume of said work and cost has risen significantly. NGET requested us to reconsider the approach to funding put in place at the last price control review because of concerns that, given the increase in costs, the existing "logging up" mechanism would expose the company to greater financial stress than envisaged.

We consider that it is appropriate to implement an explicit funding mechanism for this expenditure and not to require NG's shareholders to fund this expenditure until the next price control. We are therefore proposing to introduce a revenue adjustment term into the relevant licences.

Our consultation and responses

In August 2008 we issued a consultation which proposed modifying Special Condition D2 ("Restriction on Transmission Network Revenue") of the Electricity Transmission Licence and Special Condition C8B ("NTS Transportation owner activity revenue restriction") of the Gas Transporter Licence of NG to include a revenue adjustment term. The effect of the proposed change is to provide revenue adjustments for certain security-related costs to be passed through to consumers as part of allowed transmission owner revenue.

An equivalent income adjustment term already exists in the licences of the two Scottish transmission companies: Scottish Power Transmission (SPT) and Scottish Hydro Electric Transmission (SHETL). The proposed modification to NG's licences would allow a consistent approach across the GB transmission companies.

The consultation paper described a number of alternative approaches to funding security-related investment. These were:

- "Logging Up", which would involve a continuation of the current treatment of these costs;
- "Pass Through" of the costs, which would result in an immediate, commensurate increase in allowed revenue;
- "Income Adjustment" where the licensees' revenue is increased by the level of audited costs which, in the case of capital expenditure, includes a relevant rate of return; or
- "Direct Amendment" where the initial base revenue term determined at the last price control is amended to cover the forecast expenditure that had not been included when determining the allowance.

In addition to the proposed change to Special Condition D2 of the Electricity Transmission Licence on which we consulted in August 2008, an additional modification to Special Condition D9 of the Electricity Transmission Licence is required to add an additional cost category to paragraph 11 of 'Relevant security costs'. This additional proposed modification to D9 was not consulted on because it was a housekeeping change (adding a reference to the new clause to be included in D2 to cross reference the proposed change). For the same reasons, a similar additional proposed modification is required to C8B of the Gas Transporter Licence to add an additional cost category to paragraph 3(c)(viii), of 'Relevant security costs'.

Summary of responses

We received five responses to the consultation, none of which were marked as confidential³. All five respondents welcomed the opportunity to comment on the consultation document. Two of them raised some concerns about the absence of detailed information in the consultation. In particular one respondent cited limited information as a factor contributing to the difficulty of assessing and responding to the consultation effectively. Another respondent also expressed the view that more detailed information about the extent, breakdown and timing of actual and forecast expenditure should be provided. We were unable to release full details of this expenditure for security reasons. Annex 1 summarises the responses we received.

Ofgem's views

Having considered the responses to our August 2008 consultation document and taking account of our principal objective and statutory duties, we consider that the preferred approach to funding security-related activities is to amend NG's licences to provide for an "income adjustment". We consider this to be the most appropriate approach for the following reasons:

- this expenditure is required by government and, if accurate assessments had been possible at the time of TPCR4, the expenditure would have been included in their baseline capital expenditure; this would have increased the revenue that National Grid currently earn; and
- the proposed approach would secure regulatory consistency by bringing National Grid's licence into line with SPT's and SHETL's licences. We note that there is broad support for this approach.

The other potential approaches to funding these costs have a number of shortcomings:

- Given the level of anticipated expenditure, the "logging up" approach would place a greater strain on NG's finances than envisaged at TCPR4. NG has indicated that this approach may place an unacceptable burden on finances if it were to be adopted.
- A "pass through" approach would imply that existing customers will pay for the costs of this investment even though the investment will also benefit future customers.
- The "direct amendment" approach relies on forecast rather than actual costs. This would expose NG to the risk of changes in scope which are imposed by the security services.

Ofgem conclusions on the consultation

In light of the issues discussed above, we propose to modify Special Conditions D2 and D9 of NG's Electricity Transmission Licence and Special Condition C8B of NG's Gas Transporter Licence so that there is an explicit funding mechanism in the licences to fund efficient and economic expenditure on security for critical national infrastructure in response to new security obligations imposed upon them by Government.

Schedules 1 and 2 to this letter sets out the Notice of the Authority's intention to make the proposed modifications under section 11(3) of the Electricity Act and section 23(3) of the Gas Act.

The proposed amendments to the licence text are set out in Appendix B of Schedules 1 and 2 of this letter.

³ The responses are available on the Ofgem website:
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=16&refer=Networks/Trans/RegReporting>

If you have any comments on this letter please contact Martin Rodgers (martin.rodgers@ofgem.gov.uk) or Chris Watts (chris.watts@ofgem.gov.uk).

Yours sincerely,

Hannah Nixon
Partner, Transmission, Smarter Grids & Governance

Annex 1 – summary of responses to 2008 consultation

Questions	NG	SP	SSE	Centrica	Npower
Question 1: Do you consider the request by National Grid for an equivalent license term to the two Scottish transmission license holders to be reasonable?	Yes	Yes	Yes	Yes (provided costs are phased)	Yes
Question 2: Do you consider that licensees should have to wait for up to five years before receiving recompense on expenditure incurred at the behest of government?	No	No	No strong view, depends on the level of expenditure	Wait, but policy should be the same for all licensees	Possibly
Question 3: Which of the "alternative treatments" do you consider the most appropriate?	Income Adjustment	Income Adjustment	Income Adjustment	Insufficient information to judge	Income Adjustment or Logging Up
Question 4: Which of the "alternative rates of return" do you consider the most appropriate?	WACC	LIBOR or WACC	WACC	Debt cost	WACC

Schedule 1 - Appendix A

NOTICE CONCERNING THE PROPOSED MODIFICATION OF SPECIAL CONDITIONS D2 AND D9 OF NATIONAL GRID'S ELECTRICITY TRANSMISSION LICENCE UNDER SECTION 11(2) OF THE ELECTRICITY ACT 1989

The Gas and Electricity Markets Authority ("the Authority") hereby gives notice pursuant to section 11(2) and (3) of the Electricity Act 1989 ("the Act") as follows:

1. The Authority proposes to modify the electricity transmission licence of National Grid Electricity Transmission plc ("National Grid") treated as granted under section 6(1)(b) of the Act ("the Licence") by amending Special Licence Conditions D2 ("Restriction on Transmission Network Revenue") and D9 ("Capital Expenditure Incentive and Safety Net").
2. The primary reason why the Authority proposes to make this licence modification is to provide a method of funding security for critical national infrastructure in response to new security obligations imposed upon the licensee by Government. At the last price control a 'logging up' mechanism was introduced but because the volume and costs of the work required by Government has increased significantly we think it is appropriate to consider introducing an explicit funding mechanism. We propose to amend this to an annual income adjustment term based on the audited expenditure for completed scheme expenditure at sites and their pre-tax weighted average cost of capital at the last Transmission Price Control (TPCR4). The proposed licence modification is attached at Schedule 1 (Appendix B) to this Notice and modifies Special Licence Conditions D2 and D9 of the Licence.
3. The proposed modification to Special Licence Condition D2 introduces a revenue adjustment term into the licence. The income adjustment term already exists for the two Scottish electricity transmission licensees: Scottish Power Transmission (SPT) and Scottish Hydro Electric Transmission (SHETL). The proposed modification therefore provides the equivalent income adjustment term for National Grid Electricity Transmission. The proposed modification to Special Licence Condition D9 adds an additional cost category to paragraph 11 of 'relevant security costs'.
4. The effect of the proposed modification on the licensee is to provide revenue adjustments to reflect certain costs that can be passed through to consumers as part of allowed transmission owner revenue. More detailed reasoning for the proposed licence modification has been published by the Authority, namely:
 - a. A consultation document entitled 'National Grid Electricity Transmission and National Grid Gas Licence Amendment to include an Income Adjustment Term' dated 5 August 2008 (the August 2008 consultation document)
<http://www.ofgem.gov.uk/Networks/Trans/RegReporting/Documents/1/20080806%20Security%20Amendment%20Consultation.pdf>
5. A copy of the proposed modification and other documents referred to in this notice are available (free of charge) from the Ofgem Research and Information Centre, 9 Millbank, London SW1P 3GE (telephone 020 7901 7273) or on the Ofgem website (www.ofgem.gov.uk)
6. Any representations concerning the proposed licence modifications may be made on or before 22 July 2011 to Martin Rodgers, Office of Gas and Electricity Markets, 9 Millbank, London SW10 3GE or by email to martin.rodgers@ofgem.gov.uk.
7. All responses will normally be published on Ofgem's website and held in the Research and Information Centre. However, if respondents do not wish their response (or any part of it) to be made public then they should clearly mark their response (or a part of it) as not for publication. Ofgem prefers to receive response in an electronic form so they can be placed on the Ofgem website.
8. If you wish to discuss any aspect of this Notice, Martin Rodgers would be pleased to help.

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Hannah Nixon, Partner, Transmission and Governance

Duly authorised on behalf of the
Gas and Electricity Markets Authority
24 June 2011

Schedule 1 - Appendix B– Draft legal text

Special Condition D2 (Restriction on Transmission Network revenue)

In paragraph 2, after:

“In respect of the year commencing 1 April 2007 and each subsequent relevant year t , the maximum revenue shall be calculated in accordance with the following formula:

$$TO_t = PR_t + TIRG_t + PT_t + IP_t + CxIncRA_t + IE_t + DIS_t + ER_t + LC_t + TS_t - K_t$$

insert “+ $TOIAT_t$ ”.

In paragraph 2, after the definition of PI_t , insert:

“ $TOIAT_t$ means, in respect of each relevant year t , the amount of any income adjustment determined by the Authority in accordance with paragraph 4.”

After paragraph 3, insert the following as paragraph 4:

- “4(a) Where the licensee considers, and can provide supporting evidence, that it has incurred or saved costs and/or expenses in excess of £1,000,000 as a result of one or more transmission owner income adjusting event(s) relating to relevant security costs, the licensee shall give notice of the costs and/or expenses incurred or saved as a result of such event or events to the Authority. A notice provided to the Authority in relation to costs and/or expenses shall give particulars of:
- (i) the event(s) to which the notice relates and the reason(s) why the licensee considers each such event to be a transmission owner income adjusting event;
 - (ii) the amount of any change in costs and/or expenses that can be demonstrated by the licensee to have been incurred or saved as a result of each such event and how the amount of these costs and/or expenses has been calculated;
 - (iii) the amount of any allowed income adjustment proposed by the licensee as a consequence of each such event and how this allowed income adjustment has been calculated; and
 - (iv) any other analysis or information which the licensee considers to be sufficient to enable the Authority and the relevant parties referred to below fully to assess the event(s) to which the notice relates.
- (b) A notice under paragraph 4(a) shall be given by the licensee to the Authority as soon as is reasonably practicable after the occurrence of the transmission owner income adjusting event(s) to which it relates.
- (c) If the Authority considers that the analysis or information provided in the notice under paragraph 4(a) above is insufficient to enable both the Authority and the relevant parties referred to in paragraph 4(f) below to assess whether the transmission owner income adjusting event(s) has occurred and/or the amount of any allowed income adjustment that should be determined by it, the Authority can request that the supporting evidence be supplemented with additional information that it considers appropriate.
- (d) The Authority will make public, excluding any confidential information, any notice of an income adjusting event following its receipt.
- (e) Any notice under paragraph 4(a) should identify clearly whether any of the information contained in it is confidential. The Authority shall make the final determination as to confidentiality having regard to:
- (i) the need to exclude from disclosure, so far as is reasonably practicable, information whose disclosure the Authority considers would or might seriously prejudicially affect the interests of any person to which it relates; and
- ”

- (ii) the extent to which the disclosure of the information is necessary for the purposes of enabling the relevant parties referred to in paragraph 4(f) below fully to assess the event to which the notice relates.
- (f) The Authority shall determine (after consultation with the licensee and such other persons as it considers desirable (the “relevant parties”)):
- (i) whether any or all of the costs and/or expenses set out in any notice given under paragraph 4(a) have been incurred as a result of one or more transmission owner income adjusting event(s);
 - (ii) whether the amount of the proposed income adjustment ensures that the financial position and performance of the licensee are, insofar as is reasonably practicable, the same as if the income adjusting event(s) had not taken place and, if not, what allowed income adjustment would secure that effect; and
 - (iii) the periods, if any, over which any adjustment to the licensee’s allowed income should apply.
- (g) In relation to relevant year t , the allowed income adjustment ($TOIAT_t$) shall be:
- (i) the value determined by the Authority pursuant to paragraph 4(f) above; or
 - (ii) if the Authority has not made a determination pursuant to paragraph 4(f) within three months of the date on which notice under paragraph 4 (a) above was provided to the Authority, or if the Authority has requested further information from the licensee in accordance with paragraph 4(c) above and the Authority has not made a determination within three months of receiving such further information from the licensee, the amount of the allowed income adjustment proposed in the notice given to the Authority under paragraph 4(a); or
 - (iii) in all other cases zero, including situations where the Authority has requested additional information from the licensee in accordance with paragraph 4(c) above and the licensee has not provided that information.
- (h) The Authority’s decision in relation to any notice given under this paragraph shall be in writing, shall be copied to the licensee and shall be in the public domain.
- (i) The Authority may revoke an approval of an income adjusting event and allowed income adjustment, following consultation with the licensee and relevant parties. Revocation of any income adjusting event and allowed income adjustment shall be in writing, shall be copied to the licensee and shall be in the public domain.”

Special Condition D9 (Capital Expenditure and Safety Net)

Paragraph 11, after sub-paragraph (b), insert:

“(c) economic costs incurred by the licensee for the purpose of implementing any recommendation or requirement of the CPNI to enhance the physical security of any of the sites within the licensee’s Transmission Network”.

Schedule 2 - Appendix A

NOTICE CONCERNING THE PROPOSED MODIFICATION OF SPECIAL CONDITION C8B OF NATIONAL GRID'S GAS TRANSPORTER LICENCE (NTS) UNDER SECTION 23(3) and (4) OF THE GAS ACT 1986

The Gas and Electricity Markets Authority ("the Authority") hereby gives notice pursuant to section 23(3) and (4) of the Gas Act 1986("the Act") as follows:

1. The Authority proposes to modify the gas transporter licence in respect of the gas national transmission system of National Grid Gas plc ("National Grid") treated as granted under section 7(2) of the Gas Act ("the Licence") by amending Special Condition C8B ("NTS transportation owner activity revenue restriction").
2. The primary reason why the Authority proposes to make this licence modification is to provide a method of funding security for critical national infrastructure in response to new security obligations imposed upon them by Government. At the last price control a 'logging up' mechanism was introduced but because the volume and costs of the work required by government has increased significantly we think it is appropriate to consider introducing an explicit funding mechanism. We propose to amend this to an annual income adjustment term based on the audited expenditure for completed scheme expenditure at sites and their pre-tax weighted average cost of capital at the last Transmission Price Control (TPCR4). The proposed licence modification is attached at Schedule 2 (Appendix B) to this Notice and modifies Special Condition C8B of the Licence.
3. The proposed modification to Special Condition C8B introduces a revenue adjustment term into the Licence. The income adjustment term already exists for the two Scottish electricity transmission licensees; Scottish Power Transmission (SPT) and Scottish Hydro Electric Transmission (SHETL). The proposed modification therefore provides the equivalent income adjustment term for National Grid in respect of the NTS.
4. The effect of the proposed modification on the licensee is to provide revenue adjustments to reflect certain costs that can be passed through to consumers as part of allowed transmission owner revenue. More detailed reasoning for the proposed licence modification has been published by the Authority, namely:
 - (a) A consultation document entitled 'National Grid Electricity Transmission and National Grid Gas Licence Amendment to include an Income Adjustment Term' dated 5 August 2008 (the August 2008 consultation document)
<http://www.ofgem.gov.uk/Networks/Trans/RegReporting/Documents1/20080806%20Security%20Amendment%20Consultation.pdf>
5. A copy of the proposed modification and other documents referred to in this notice are available (free of charge) from the Ofgem Research and Information Centre, 9 Millbank, London SW1P 3GE (telephone 020 7901 7273) or on the Ofgem website (www.ofgem.gov.uk)
6. Any representations concerning the proposed licence modifications may be made on or before 22 July 2011 to Martin Rodgers, Office of Gas and Electricity Markets, 9 Millbank, London SW10 3GE or by email to martin.rodgers@ofgem.gov.uk
7. All responses will normally be published on Ofgem's website and held in the Research and Information Centre. However, if respondents do not wish their response (or any part of it) to be made public then they should clearly mark their response (or a part of it) as not for publication. Ofgem prefers to receive response in an electronic form so they can be placed on the Ofgem website.

8. If you wish to discuss any aspect of this Notice, Martin Rodgers would be pleased to help.

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Hannah Nixon, Partner, Transmission and Governance
Duly authorised on behalf of the
Gas and Electricity Markets Authority
24 June 2011

Schedule 2 - Appendix B – Draft legal text

Special Condition C8B

In paragraph 3(a) after:

“For the purposes of paragraph 1 of this condition, the maximum NTS transportation owner revenue in respect of formula year t (TOMR_t) shall be calculated using the following formula:

$$\text{TOMR}_t = \text{TOZ}_t - \text{TOZA}_t + \text{TOF}_t + \text{TOG}_t - \text{TOK}_t$$

insert “+ TOIAT_t”.

In paragraph 3(a), after the definition of TOK_t insert:

“TOIAT_t means, in respect of each formula year t, the amount of any income adjustment determined by the Authority in accordance with paragraph 3(e) of this condition.”

In paragraph 3(c)(viii), after sub-paragraph (aa), insert

“(bb) economic costs incurred by the licensee for the purpose of implementing any recommendation or requirement of the CPNI to enhance the physical security of any of the sites within the licensee’s Transmission Network”.

After paragraph 3(d), insert the following as paragraph 3(e):

“3(e) NTS transportation owner income adjustment (TOIAT)

- (i) Where the licensee considers, and can provide supporting evidence, that it has incurred or saved costs and/or expenses in excess of £1,000,000 as a result of one or more transmission owner income adjusting event(s) related to relevant security costs, the licensee shall give notice of the costs and/or expenses incurred or saved as a result of such event or events to the Authority. A notice provided to the Authority in relation to costs and/or expenses shall give particulars of:
 - (aa) the event(s) to which the notice relates and the reason(s) why the licensee considers each such event to be a transmission owner income adjusting event;
 - (bb) the amount of any change in costs and/or expenses that can be demonstrated by the licensee to have been incurred or saved as a result of each such event and how the amount of these costs and/or expenses has been calculated;
 - (cc) the amount of any allowed income adjustment proposed by the licensee as a consequence of each such event and how this allowed income adjustment has been calculated; and
 - (dd) any other analysis or information which the licensee considers to be sufficient to enable the Authority and the relevant parties referred to below fully to assess the event(s) to which the notice relates.
- (ii) A notice under paragraph 3(e)(i) shall be given by the licensee to the Authority as soon as is reasonably practicable after the occurrence of the transmission owner income adjusting event(s) to which it relates.
- (iii) If the Authority considers that the analysis or information provided in the notice under paragraph 3(e)(i) above is insufficient to enable both the Authority and the relevant parties referred to in paragraph 3(e)(vi) below to assess whether the transmission owner income adjusting event(s) has occurred and/or the amount of any allowed income adjustment that should be determined by it, the Authority can request that the supporting evidence be supplemented with additional information that it considers appropriate.

- (iv) The Authority will make public, excluding any confidential information, any notice of an income adjusting event following its receipt.
- (v) Any notice under paragraph 3(e)(i) should identify clearly whether any of the information contained in it is confidential. The Authority shall make the final determination as to confidentiality having regard to:
 - (aa) the need to exclude from disclosure, so far as is reasonably practicable, information whose disclosure the Authority considers would or might seriously prejudicially affect the interests of any person to which it relates; and
 - (bb) the extent to which the disclosure of the information is necessary for the purposes of enabling the relevant parties referred to in paragraph 3(e)(vi) below fully to assess the event to which the notice relates.
- (vi) The Authority shall determine (after consultation with the licensee and such other persons as it considers desirable (the “relevant parties”)):
 - (aa) whether any or all of the costs and/or expenses set out in any notice given under paragraph 3(e)(i) have been incurred as a result of one or more transmission owner income adjusting event(s);
 - (bb) whether the amount of the proposed income adjustment ensures that the financial position and performance of the licensee are, insofar as is reasonably practicable, the same as if the income adjusting event(s) had not taken place and, if not, what allowed income adjustment would secure that effect; and
 - (cc) the periods, if any, over which any adjustment to the licensee’s allowed income should apply.
- (vii) In relation to formula year t , the allowed income adjustment ($TOIAT_t$) shall be:
 - (aa) the value determined by the Authority pursuant to paragraph 3(e)(vi) above; or
 - (bb) if the Authority has not made a determination pursuant to paragraph 3(e)(vi) within three months of the date on which notice under paragraph 3(e)(i) above was provided to the Authority, or if the Authority has requested further information from the licensee in accordance with paragraph 3(e)(iii) above and the Authority has not made a determination within three months of receiving such further information from the licensee, the amount of the allowed income adjustment proposed in the notice given to the Authority under paragraph 3(e)(i); or
 - (cc) in all other cases zero, including situations where the Authority has requested additional information from the licensee in accordance with paragraph 3(e)(iii) and the licensee has not provided that information.
- (viii) The Authority’s decision in relation to any notice given under this paragraph shall be in writing, shall be copied to the licensee and shall be in the public domain.
- (ix) The Authority may revoke an approval of an income adjusting event and allowed income adjustment, following consultation with the licensee and relevant parties. Revocation of any income adjusting event and allowed income adjustment shall be in writing, shall be copied to the licensee and shall be in the public domain.”