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Dear Gareth

TPCR4 rollover Initial Proposals: consultation response

National Grid owns and operates the high voltage electricity transmission system in England and Wales and as National Electricity Transmission System Operator (NETSO), operates the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain. The issues addressed in this consultation directly affect National Grid.

National Grid's Transmission businesses (National Grid) welcome the opportunity to work with Ofgem to ensure that the outcome for the TPCR4 rollover strikes a balance between protecting the interests of consumers and ensuring that adequate funding is made available to maintain safe and reliable operations of the assets as we prepare to efficiently meet future challenges.

This rollover arises from a decision made by Ofgem following the RPI-X@20 review; it should not lead to a delay of the activities necessary to deliver future network outputs in a timely way. The Initial Proposals contain some positive developments following Ofgem's Initial Thinking published in April. There are however, a number of material issues which need to be resolved to ensure that the efficient delivery of network outputs is not adversely affected by the rollover and we are concerned at an apparent desire to defer decisions on investment to the RIIO-T1 review.

Our response is in four parts: this letter, a response to the questions asked in the consultation, a follow-up information pack covering issues on which Ofgem has requested a more in-depth response, and responses to Ofgem's recent questions regarding rollover/RIIO-T1 reconciliations.

Our ambition is to provide transmission networks that facilitate the delivery of the UK's climate change targets whilst maintaining security of gas and electricity supplies. Our stakeholders have confirmed that these objectives, alongside the need for us to operate a safe and efficient system, remain their priorities.

Against this background we have a number of material concerns with the Initial Proposals; however, we look forward to working with Ofgem to ensure that it has sufficient information to agree to fund investments in critical areas such as workforce renewal and growth, asset health and renewal of the critical IT systems which support the efficient and reliable delivery of network outputs. In addition, we have a number of concerns with regard to certain policy

decisions – and their application – such as the capex incentive, gas permits scheme and the proposed reduction in the allowed cost of debt.

The remainder of this letter covers the high level issues, which are expanded on in our detailed response document, supplemented by the additional information submitted separately to Ofgem.

Opex

Our two main areas of concern regarding opex are the proposed allowances for workforce renewal and growth and Ofgem's assumed efficiencies. Funding of NGET and NGG opex at the level in the Initial Proposals would have material, adverse impacts on delivery of stakeholder requirements in both 2012/13 and the RIIO-T1 period. There are clear incremental workload drivers between Ofgem's base year of 2009/10 and 2012/13, including the need to train and recruit resources in advance of the RIIO-T1 period. In addition, we have embedded over 3% per annum efficiencies in our plan for 2009/10 to 2012/13, well above the historical regulatory precedent of 1.0% to 1.5% per annum. Against this background, the Initial Proposals for controllable opex (in 2009/10 prices excluding non-operational capex) allow less than our expenditure in 2009/10.

For workforce renewal and growth, around two-thirds of our proposed investment relates to expected attrition and retirements, based on assumptions which are in line with EU Skills modelling. Ofgem's Initial Proposals only fund half of our workforce renewal and growth costs for 2012/13 and, therefore, do not provide sufficient funding for us to maintain our current resource levels, let alone grow our workforce ahead of RIIO-T1.

Whilst the forecast recruitment numbers are challenging, we recruited nearly 300 FTEs in 2010/11, and are on track to recruit nearly 500 more in 2011/12, over 200 of whom will have started work by the end of this month. This demonstrates that we (a) can deliver the recruitment outlined in our rollover submission, and (b) are already undertaking (at our shareholders' expense) similar expenditure to that proposed for 2012/13 due to its essential nature. We would welcome the chance to show Ofgem the investment we are making at our training centre in Eakring, Nottinghamshire.

In addition to assessing each of the upward cost drivers, Ofgem's Initial Proposals embed an ongoing efficiency target of 1.5% per annum into the proposed allowances, plus a £4m 'catch-up' efficiency for ETO due to our opex spend exceeding TPCR4 allowances.

NGET and NGG already have efficiency targets embedded into their plans, totalling 3.7% per annum for ETO and 2.7% per annum for GTO. These incorporate a 'catch-up' efficiency where benchmarking or market testing has shown that improvements can be made (for example, savings from our support function transformation programmes). Ofgem's £4m efficiency is therefore double counting this 'catch-up' efficiency. Outside of these areas, we have presented evidence that our opex compares well to that of our peers, e.g. under mature benchmarking studies ITOMS and GTBI. Using the TPCR4 opex allowances – which have proved inadequate for ETO during the period – as a proxy for the efficient level of expenditure is too simple an assessment, as several key cost drivers, such as the price of electricity, have materially changed since the allowances were set. The efficiency levels we have embedded into our plan are set out in our detailed response, but these targets do not end with the rollover year. We have included year-on-year opex efficiency improvement targets of 1.7% and 1.3% for NGET and NGG respectively throughout the RIIO-T1 period.

The above paragraphs cover our main areas of concern regarding Ofgem's opex proposals, although there are other areas of the proposals with which we disagree. Our responses to these proposals can be found in our detailed response document.

Non-operational capex

The Initial Proposals for non-operational capex question whether some of the projects we have forecast for 2012/13 will actually be delivered. In our detailed response, we explain that the three main projects disallowed – our condition monitoring work in Strategic Asset Management (SAM), the High Pressure Monitoring Information System in NGG and asset health work on the Transmission Front Office (TFO) – are already sanctioned and we are already spending money delivering the projects. Deferring these projects from 2012/13 would not only be inefficient (because we would have to stop ongoing development giving rise to increased cost in the longer term), it would also impact on reliability and safety of the network.

The Initial Proposals state that non-operational capex for 2012/13 should be kept at levels closer to historical averages. This suggests that non-operational capex is being considered as opex, rather than – as it is – capex in nature. Costs may be funded like opex but the 2012/13 projects are based on both asset refresh of existing IT assets and new capabilities that will help deliver and minimise future capital requirements. For example, initial work on the SAM investments (total investment of £4.1m in 2012/13) has already avoided costs in 2011/12 through risk mitigation and avoided asset (transformer and GIS) failures that would otherwise have impacted on safety and reliability. Continuing investment in 2012/13 helps us to extend this condition monitoring capability to more of our ageing assets, allowing us to maintain reliability and safety outputs. Reductions in this investment in 2012/13 will have the effect of delaying and reducing our assumed efficiencies during the RIIO-T1 period.

Capex

The capex allowances for load related investments have largely been allowed, with the exception of the gas network flexibility investments.

There has historically been no recognition in the commercial framework of the evolution of needs of existing National Transmission System (NTS) users, with a zero base allowance for network developments explicitly indicating that the needs of existing network users will remain static. This assumption is no longer valid, with supplies dramatically changing now and in the future and demand patterns expected to change over the next decade.

In addition, the NTS has been designed to manage peak demand days; however, many of the expected issues will arise away from peak demand. This brings into question the validity of the existing design standards. We have already started discussions with stakeholders on the appropriateness of using the 1 in 20 winter peak as a design standard, and we will continue this debate at our next stakeholder event in November 2011.

Given these changing assumptions, the majority of the capabilities necessary to manage the future gas flows were not, and could not, have been reasonably considered when setting existing revenue drivers and have therefore not been funded before.

It is imperative that, given the lack of credible alternatives to a physical solution in Scotland, some of these investments are progressed at the earliest opportunity to ensure we can continue to meet our 1 in 20 obligations and therefore maintain security of supply. Whilst the Initial Proposals do not support these investment requirements, to mitigate disruption to existing and future consumers we are now progressing investment options related to moving

gas north into Scotland, as we do not believe it appropriate to allow Scottish demand to bear the increasing risk. Delaying the start of this work by 18 months through lack of funding in 2012/13 will further increase risks to Scottish demand when St Fergus supplies are low.

Enhanced capabilities in the heart of the NTS are also necessary to manage evolving east to west and west to east gas flows and to meet the forecast needs of our customers. These capabilities minimise future commercial risk, and failure to do this increases the risk of material system management costs to both ourselves and the end consumer.

The capex allowances for non-load related work for gas have largely been allowed, with some notable exceptions, including Feeder 9 in the Humber Estuary. The work to be completed on Feeder 9 is asset health investment to maintain current levels of capacity and should not be confused with any work to deliver incremental capacity. Our approach to Feeder 9 has always been two fold:

- To progress the identified mitigation measures in order to secure Feeder 9 in the short to medium term
- To develop an enduring solution, such that we can undertake a risk assessment to establish the optimal solution. We will review the success and anticipated longevity of the mitigation measures, evaluating and balancing the risk of incurring an unavoidable isolation of Feeder 9 with consequential security of supply and commercial ramifications.

There is no credible scenario where we would not incur costs in relation to this project in 2012/13, as the spend is not reliant on planning permission but is essential in order to complete the key activities in preparation of an anticipated submission of a Development Consent Order request under the Planning Act.

For electricity non-load related capex, we are concerned about the quality of KEMA's unit cost and overheads analysis, and the way that this has been applied. The lack of subsequent engagement in this area has made it difficult for us to provide new information as we do not fully understand what is required and where our differences lie.

Furthermore, an extrapolation of historical average TPCR4 spend is not appropriate when we need to step up delivery and address new challenges. Our ambition is to be allowed to smoothly and incrementally move up to a longer-term position from where we can meet the challenges posed by facilitation of the UK's 2020 environmental targets whilst also maintaining a safe, reliable and environmentally-acceptable network. While short-term deferral and delays will not impact safety and reliability in the rollover year when considered in isolation, we are considering the next ten years and the economic and efficient path to 2020.

Gas Permits scheme

The Permits scheme was originally designed to incentivise us to release incremental capacity ahead of the obligated lead times for entry (42 months) and exit (38 months), as set out in the licence. As it was implemented before the Planning Act (2008) came into force, it was never intended for this scheme to be used as mitigation for the impact of the changes to the planning regime.

The scale of potential applications for incremental capacity in 2012/13 is large, both on exit (potential and probable applications from CCGTs) and entry (potential applications from large scale storage and LNG importation). Many of the developers of these potential projects already have planning consent (from applications submitted before the Planning Act came

into force); however, any subsequent NTS reinforcements will require planning consent under the Planning Act. This misaligns the timescales required for delivery of the third party projects and delivery of the network reinforcements to support them by a number of years.

We are working to develop a process which will, in future, help align our timescales to those of the developers of new projects, thereby minimising this issue. Until this point, however, there remains the risk of developers with planning consent already granted under the old regime wishing to connect to the NTS ahead of when it is possible to reinforce the network under the new planning regime. Tools will be required in the RIIO-T1 period to help manage these situations and we expect to develop these through the RIIO-T1 process.

Ofgem's proposal to pro-rate the TPCR4 permits scheme for 2012/13 is a reasonable one. We agree that the value of the scheme should be pro-rated; however, we are concerned about the volume of probable and possible incremental capacity signals in 2012/13. We therefore propose that the price of each permit is pro-rated (i.e. is reduced to one fifth of the TPCR4 level) and the volume of permits is maintained at TPCR4 levels. We would like to discuss this further with Ofgem.

Capex incentive

We do not support the spreading of the capex incentive adjustment (CxIncRA term) over a number of years and believe the adjustment should be made in full in 2012/13 on a provisional basis. This is expanded on within our detailed response however, in summary, we do not believe transmission charges will fluctuate if the incentive is paid in 2012/13 and so do not agree that there is a need to spread the adjustment to avoid fluctuations. Furthermore, the proposal represents a breach of regulatory commitment, being contrary not only to the TPCR4 Final Proposals, but to the regulatory contract (licence) itself. Investors in long-term assets take note each time a regulator ignores earlier commitments it has made because such behaviour undermines any future promises that the regulator may make. The long-term result of such behaviour is to increase perceptions of regulatory risk and increase the cost of capital faced by consumers.

The capex incentive adjustment relates to past performance and is due, in large part, to setting uncertainty mechanisms that did not provide incremental revenues during the TPCR4 period. Any further delay to the recovery of these revenues, even if undertaken in a manner consistent with the cost of capital underlying the parameters defined in the TPCR4 capex incentive mechanism, would represent a further strain on our finances. Such delays would also mean that costs giving TPCR4 benefits are imposed disproportionately on future customers.

Cost of capital

We agree with Ofgem's proposal to leave the cost of equity unchanged at 7.0% and to maintain the notional gearing level at 60%. However, we oppose the decision to reduce the cost of debt to 3.25%. Ofgem has clearly stated in their Initial Proposals (paragraph 4.12) that the return will be set using the approach used in TPCR4, which was largely based on the Smithers report. That approach focused on long-term rates.

The proposed reduction in the cost of debt is based on a reduction in the risk-free rate from 2.5% to 2.0% and Ofgem's interpretation that Smithers had a range of 2.0 to 2.5% for the risk-free rate.

Ofgem has misrepresented the Smithers report with regard to the risk-free rate – the TPCR4 Final Proposals explicitly used a long-term estimate of the risk free rate (2.5%) in deriving a

figure for the cost of debt and Smithers did not, as Ofgem claims, give a range from 2.0% to 2.5% for this parameter. Rather, the 2.5% was consistent both with the point estimate of the risk-free rate from Smithers, and with the bottom of the range for the real long-term risk-free yield from 2.5% to 3.25% in the Summary section of the Smithers report. The 2.0% to 2.5% range in the Smithers report which Ofgem now refers to was merely a (then) current estimate of the forward looking rate, which was part of a consideration of term premia which fed into the final conclusion on real long-term risk-free yield, i.e. the range from 2.5% to 3.25%, in the report.

With regard to the evidence of a reduction from 2.5 to 2.0%, Ofgem is relying heavily on short- and medium-term data and on gilts with an inappropriately short tenor. Our detailed response demonstrates that when more appropriate 15, 18 and 20 year gilts are considered, the evidence does not support a material reduction in the long-term risk-free rate. Further, if Smithers' view of using current information on nominal gilt rates is applied correctly, the future rates implied in the yield curve need to be considered. When this is done, again the evidence does not support the proposed reduction in the long-term risk-free rate, as shown in our and Scottish Power's May 2011 rollover Initial Thinking responses.

It is clear, therefore, that for the prescribed approach of setting the allowed return for the rollover in a manner consistent with that in TPCR4 – an approach with which we agree – a reduction in the long-term risk-free rate cannot be justified and so the cost of debt should not be reduced.

Furthermore, if, after considering the arguments in this response, Ofgem was to change the approach to setting the allowed return to move away from a consideration of long-term rates and the Smithers report, such a change would demonstrate a breach of regulatory commitment which would further increase investor perceptions of regulatory risk, discourage investment in the energy sector, and increase the cost of capital.

In conclusion

We recognise that there are some areas of expenditure where Ofgem requires further information and we continue to be happy to facilitate this and will work with Ofgem over the coming months.

Yours sincerely

Pauline McCracken

Transmission Price Review Manager