Promoting choice and value
for all gas and electricity customers

TPCR4 Rollover: Draft licence conditions – Informal consultation

Consultation

Reference:	138/11	**Contact:**	Gareth Walsh
Publication date:	21 October 2011	**Team:**	Transmission
Response deadline:	18 November 2011	**Tel:**	020 7901 1867
		Email:	Gareth.Walsh@ofgem.gov.uk

Overview:

The existing gas and electricity transmission price controls (TPCR4) expire on 31 March 2012. To enable the next price controls to fully reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model for regulation, in December 2009 we decided to delay implementation of the new price controls until 1 April 2013. We will therefore implement a one-year rollover of TPCR4 to operate in the period 1 April 2012 to 31 March 2013.

To give effect to these proposals we will need to modify the licences of each transmission company. The modification of the licenses requires a formal or "statutory" consultation. We consider it important to engage stakeholders at the earliest stage possible; in advance of the statutory consultation, we are publishing this "informal" consultation.

The purpose of this informal consultation is to allow stakeholders an early opportunity to comment on our proposed changes. Within this document, we outline the licence changes we consider are needed. We have included working drafts of the relevant proposed licence conditions to help inform readers.

Context

The current price control (TPCR4) will be rolled over by one year in response to the Authority's decision to delay the implementation of RIIO-T1 until 1 April 2013. Recognising it's a one-year price control, means reflecting recent policy developments, not delaying critical investment and, as far as practical, facilitating the development of RIIO-T1. We consulted on our initial proposals for the rollover year in August. We will publish our Final Proposals in November 2011.

Implementation of our Final Proposals will require formal modifications of the licences of each of the electricity transmission companies and National Grid Gas National Transmission System's (NGG NTS) gas transporter licence.

This document consults on our current thinking as to how the licences of National Grid Electricity Transmission plc (NGET), Scottish Power Transmission Limited (SPTL), Scottish Hydro Electric Transmission Limited (SHETL) and the gas transporter licence of NGG NTS should be amended to implement the TPCR4 rollover price control. We have referred to this consultation as an informal consultation to differentiate it from the statutory consultation we will undertake after publication of our final proposals. While the document reflects the position we set out in our Initial Proposals document, additional licence changes may be required where the approach we outline in our final proposals deviates from this.

We welcome views on any aspect of the proposed changes set out in this document and appendices. Following consideration of respondents' views, we intend to publish a second (statutory) consultation on licence drafting shortly after our final proposals in November 2011. The final licence modification notices to the licences will be published in December 2011.

Associated documents

Draft rollover licenses

NGG: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/NGG-NTS%20Rollover%20special%20conditions.pdf

NGET: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/NGET%20Rollover%20special%20conditions.pdf

SHETL: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/SHETL%20Rollover%20special%20conditions.pdf

SP: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/SP%20Rollover%20special%20conditions.pdf

Previous price control documents
TPCR4 Rollover: Initial Proposals, 2 August 2011:

http://www.ofgem.gov.uk/NETWORKS/TRANS/PRICECONTROLS/TPCR4ROLL-OVER/Documents1/110802TPCR4RolloverIP.pdf

Contents

Executive Summary

Great Britain's (GB's) gas and electricity transmission companies face significant challenges over the coming years to develop the transmission infrastructure necessary to meet environmental challenges and to secure energy supplies. We are committed to ensuring these challenges are met in a way that provides value for money for consumers.

In light of these challenges and scale of investment required, we recently undertook a detailed review of energy network regulation, RPI-X@20. The review looked at how best to regulate energy network companies to enable them to meet these challenges. The review concluded with the introduction of the RIIO framework[1] in October 2010. The existing transmission price control, Transmission Price Control Review 4 (TPCR4), covers the period from 1 April 2007 to 31 March 2012. To allow us to implement our new regulatory model, RIIO, at the next full price control, we are rolling over the current control for one year to cover the period from 1 April 2012 to 31 March 2013. We refer to this one-year extension as the "TPCR4 rollover".

We will be publishing our final proposals next month. To give effect to these proposals we will need to modify the licences of each of the three electricity transmission licensees and NGG NTS. Following discussions with the licensees, this document outlines the changes we propose to the electricity and gas licences in light of our TPCR4 Rollover proposals. This will involve changes to the transmission licences of NGET, SPTL, SHETL and the gas transporter licence of NGG NTS. As we have adopted a proportionate approach to the rollover – broadly speaking we are extending exiting policy – the level of change is relatively small. The most significant changes to the licences are to reflect our updated methodology for RPI indexation and make the revenue adjustments in line with the capital expenditure (capex) incentive mechanism in place during TPCR4 to incentivise efficient capital investment. This mechanism is to be extended into the rollover year and the associated licence drafting is included within this document.

We have included our proposed licence drafting in supplementary documents. We hope that this will aid the understanding of the reader.

[1] http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf

1. Principles and Scope

Chapter Summary
This chapter outlines the principles which have guided our licence drafting for the TPCR4 rollover and clearly identify the scope of the licence changes proposed in this document and the supporting appendices.

Guiding principles and Scope

1.1. This document focuses on the proposed changes to the electricity transmission licences of NGET, SPTL and SHETL and the gas transporter licence of NGG NTS which arise as a result of the proposals set out in our TPCR4 rollover initial proposals document. We have consulted on these proposals in various documents throughout the TPCR4 rollover process.

1.2. We consider that the proposed licence changes are proportionate to a one-year control. We believe that they strike an appropriate balance between our principal objective to protect existing and future consumers, whilst being proportionate to a one-year control.

1.3. In line with our approach to the rollover, we have taken a proportionate approach to licence drafting. House-keeping changes have been kept to a minimum and the licence only refers to the revenue adjustments that will be made in the rollover year. We acknowledge that there are a number of revenue adjustments that will need to be made subsequently, as part of the RIIO price control. We will clearly describe these revenue adjustments in our final proposals and they will feed into the RIIO licence drafting process. Examples of these include:

- The true up of the TPCR4 capex incentive
- The capex incentive based on expenditure and revenue driver adjustments during the rollover year

Interactions with the Third Package

1.4. The Third Energy Package is a suite of legally binding European Union legislation, a key objective of which is to deliver greater structural separation of networks from generation/production and supply activities. On 18 July 2011, the Department of Energy and Climate Change ('DECC') laid before Parliament the draft GB regulations, which will transpose the Third Energy Package into UK law, (the "draft regulations").

1.5. Subject to approval by Parliament, these proposals will amend domestic legislation, including the Gas Act 1986 ('the Gas Act') and the Electricity Act 1989 ('the Electricity Act')[1]. The proposed changes include a new procedure for making licence modifications and removing the provisions allowing the Authority to make a modification reference to the Competition Commission under s24 Gas Act and section 12 Electricity Act.

1.6. The special licence condition through which a licensee can make a disapplication request (a request to terminate their licence), are licence condition D8 for NGET, J9 for SHETL / SP and C8B for NGG. Currently these conditions expressly refer to modification references under the Gas Act and Electricity Act. Accordingly, if and when the draft regulations are approved by Parliament, these special conditions will need to be modified to take account of the change in law. This modification will itself be carried out through the new licence modification process set out in the draft regulations.

This document

1.7. **Chapter 2** outlines the amendments to the licences common across all TOs. These include changes to base revenue as a result of adjustments to the retail price index (RPI), equity issuance, logged up and passed through costs. In Chapter 2 we will also outline how our proposed approach to the capex incentive will be implemented.

1.8. **Chapter 3** discusses the changes that are specific to the electricity licensees, and **chapter 4** presents the changes to NGG's licence.

1.9. **We have published the draft text of the rollover licenses in parallel with this consultation**. We have only published those special licence conditions that will be changing in the rollover year.

1.10. A final decision on the values for inclusion in the licence (such as allowed return and operational / capital allowances) will be made in our final proposals; within the draft licence conditions we have not included any of these parameters. We consider this is sufficient to allow parties to consider and provide views on the form of the proposed conditions in advance of us finalising these values.

1.11. We are in the process of reviewing responses to the initial proposals consultation that closed on 12 September 2011. We will be issuing final proposals in November, with which we will include the updated licence conditions. We then aim to finalise the licence changes in December 2011, in advance of issuing a statutory consultation on these licences early in 2012.

1.12. Our proposals include amendments to various licence conditions. The process of amending licences will be carried out in accordance with the procedures set out in Section 11 and Section 11A of the Electricity Act 1989 and Section 23 of the Gas Act. Our changes will be informed by responses to this document and to our final proposals.

1.13. Responses should be received by 18th Nov 2011 and should be sent to:

Gareth Walsh
Senior Manager, Transmission and Governance
Transmission
9 Millbank
London
SW1P 3GE
Tel: 020 7901 1867

Email: gareth.walsh@ofgem.gov.uk

1.19. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.20. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

2. Proposed changes common to all licensees

Chapter Summary

There is considerable overlap between the licenses of the gas and electricity transmission licensees. Both, for example incentivise efficiency through a "capex incentive", and both use pass through logging up mechanisms to manage uncertainties. This chapter discusses in detail our approach to these common items.

Question 1: We invite stakeholders to comment on the proposed licence changes outlined in chapter 2.

Base revenue terms

Retail Price Index (RPI) approach

2.1. In line with our decision letter issued in the summer[2], we will amend our approach to retail price indexation. On 30 March 2011, National Grid brought to our attention an issue with the method we have traditionally used for indexing allowed revenues for economy-wide inflation, as measured by the RPI. The principles behind the method are to protect network companies against economy-wide inflation while protecting consumers against network companies gaining additional allowed revenues due to movements in RPI.

2.2. The indexation method has not changed since privatisation, but a problem has now arisen due to the period of very low/negative inflation in 2009-10. We estimated that if the methodology remained unchanged, by the end of the RIIO-T1 and RIIO-GD1 price control period (from 2013 to 2021) network companies will not have been able to fully recover our assessment of their efficient costs, as determined at the RIIO price control review that is currently under way.

2.3. The new approach to indexing allowed revenues in RIIO-T1, RIIO-GD1 and the TPCR4 rollover removes the lag present in the current methodology. It uses a forecast of RPI growth to inflate allowed revenues in each charging year. An annual true-up adjustment, with a two year lag, then protects network companies and consumers against any differences between forecast RPI and actual RPI.

2.4. For example, in setting allowed revenues for the first year of the RIIO price controls in 2013-14, it will work as follows. At the time of the price control, allowed

[2] Decision on the RPI indexation method to apply to allowed revenues in the forthcoming RIIO price controls (T1 and GD1) and the TPCR4 rollover: July 2011 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RPI%20Issue%20-%20Decision%20Letter.pdf

revenues will be set in 2009-10 prices. The licence will then calculate allowed revenues (in the prices of the charging year) by uplifting these values for RPI growth using the following two components:

- Growth in average RPI between April 2009 – March 2010 and April 2011 – March 2012 using actual RPI data.
- Forecast growth in RPI between April 2011 – March 2012 and April 2013 – March 2014 (the subsection below sets out further details of our approach).

2.5. An annual true-up adjustment, which operates with a two-year lag, will then adjust allowed revenues to account for any differences between forecast RPI (in the second bullet above) and actual outturn RPI.

2.6. We propose that the licence includes all items of revenues (including incentive rates) in 2009-10 prices to simplify the calculations in the licence. In addition, we plan that incentives will typically be settled with a two year lag so that:

- The data is available at the time of setting allowed revenues.
- The relevant RPI adjustments only need to use actual RPI data without any true-ups being required.

2.7. This option provides protection for the network companies against inflation. Although there is a risk of some increase in volatility in allowed revenue, and therefore in charges, we believe that the use of an RPI forecast from a widely available and reputable source will provide transparency to suppliers when they set their charges.

Uncertainty mechanisms

Logged up costs

2.8. Logged up costs will not enter the Regulatory Asset Value (RAV) until 1 April 2013, after we have undertaken a full efficiency review. With the exception of NGG's costs for quarry and loss, costs will not continue to log up during the TPCR4 rollover. We discuss our approach to quarry and loss costs in detail in chapter 4. The definition of logged up costs (via the licence term LC_t) has been updated in the licence to reflect this[3].

Pass through costs

2.9. The current set of pass-through costs will continue to be passed through. In doing so we need to determine the ex-ante revenue allowance for a number of costs.

[3] Though not provided for explicitly in the licence, costs associated with physical security infrastructure upgrades will log-up, entering the RAV once they are complete and a full efficiency review has been carried out.

Revenue will be adjusted in the RIIO price control to account for any over / under recovery against outturns. As a result the only changes required to special conditions J4 (Scottish Electricity licensees) C8B (NGG), and D4 (NGET) are to set the following ex-ante allowances[4]:

- SHETL Network Rates
- SP Network Rates
- NGET Licence fee, Non Domestic rates allowance
- NGG Licence fee, Independent system cross subsidy

The term $Rate_t$ was used in NGET's licence to reconcile non-domestic rates from the price control prior to TPCR4. This is no longer required and has been removed from the non domestic rates revenue adjustment formulae.

NGET is allowed to pass through costs associated with interruption payments. To ensure they are passed through on a neutral Net Present Value (NPV) basis they are allowed to recover financing costs to account for any delay. These financing costs will be based on the allowed return for the rollover year.

Capex Incentive and the Capex Safety Net

2.10. This revenue adjustment serves the dual purpose of granting additional revenue or clawing back revenue where the actual capex profile during the price control differs from that assumed when setting the base revenue and exposing the licensees, through a revenue adjustment to 25% of any over- / under-spend.

2.11. In making any changes to the rollover licence we must consider both the revenue adjustments that will take place in line with expenditure during the current price control (TPCR4), and outputs from the rollover price control. Our policy, as communicated in our initial proposals document is outlined below:

Revenue adjustment in line with outturns during TPCR4

2.12. In our initial proposals we proposed to calculate the TPCR4 capex incentive for each for the licensees on a provisional basis (provisional as neither the outturns from 2011/12 would be known nor would we have had an opportunity to undertake an efficiency review of TPCR4 expenditure) and smooth the revenue adjustment over a number of years. We considered this appropriate to protect consumers from fluctuations in transmission charges. The licensees disagreed with this approach. We will reconsider whether smoothing is appropriate when determining our final proposals, considering, amongst other factors, the magnitude of the changes to transmission prices in the rollover year, the possible magnitude of the changes to transmission charges for the RIIO price control and the financeability of the licensees.

[4] Note these ex-ante allowances will be inflated via the new methodology to RPI detailed earlier in this chapter

2.13. Regardless of our decision on smoothing, the licence will be updated for the rollover year to award revenues to realise the TPCR4 capex incentive (or a part thereof). We propose this number to be hard coded into the licence. We are committed to truing up any difference between this revenue adjustment and the recalculated revenue adjustment in 2014, once all of the inputs into the formula are known and an efficiency assessment has been carried out. The associated revenue adjustment will be made on an NPV neutral basis (based on the rollover allowed return for the year 2012-13, and the RIIO allowed return for the year 2013-14). Inclusion of this adjustment in the RIIO licence will be addressed as part of the RIIO licence drafting work-stream.

Revenue adjustment in line with outturns during the rollover year

2.14. In our initial proposals we communicated our intention to continue to incentivise efficiency through the extension of the capex incentive into the rollover year. We considered it appropriate to maintain the sharing factor at 25%. It will not be until summer 2013, when the licensees have submitted their regulatory reporting packs that we will know the outturns from the rollover year, both in terms of capital expenditure and, in the case of the electricity licensees, outputs that will drive an adjustment in their capex allowance via the revenue drivers (discussed further in chapter 3). For this reason the capex incentive adjustment for the rollover year will be realised in the 2014-15 revenue[5]. As with the rollover capex incentive the adjustment will consist of a true up of the return granted in the rollover year where actual capex did not match the allowances and expose the licensees to 25% of any over- / under-spend. As with the true up of TPCR4 revenue driver adjustment, we consider the timing of the adjustment renders it inappropriate to include detailed workings in the rollover licence, and we are committed to making the adjustment on an NPV neutral basis (based on the RIIO allowed return for the year 2013-14). The impact of the Revenue drivers on the calculation of the capex incentive for the electricity licensees is discussed in detail in chapter 3.

Capex incentive safety net

2.15. Through the capex incentive safety net the Authority have the right to make an adjustment to the capex allowance where the licensee, in any given year, spends less than 80% of their allowance. We propose it is appropriate to maintain this safety net for the rollover year. During TPCR4, to ensure this comparison was being done on an equal basis, logged up costs and, in the case of the electricity licensees, revenue driver additions were subtracted from their actual expenditure in advance of undertaking the comparison. For the rollover year we consider it no longer necessary to subtract these items for the electricity licensees since: 1) no costs will continue to log up during the rollover year; 2) As we describe in chapter 3, a provisional allowance for "Revenue Driver" projects has already been included in the base capex allowance. In line with this approach the capex figure used in this comparison term BCx will be the sum of the base and "revenue driver" capex allowances. Logged up costs for quarry and loss will continue to be subtracted from NGG's actual capex.

[5] For a fuller explanation see page 28 of our initial proposals

3. Proposed changes specific to the Electricity Licensees

Chapter Summary

This chapter outlines, for comment, the licence modifications we are proposing to give effect to our TPCR4 Rollover proposals for the electricity licensees

Question 2: We invite stakeholders to comment on the proposed licence changes outlined in chapter 3.

Equity Issuance

3.1. In line with our initial proposals each of the electricity TO licences have been updated to include an allowance for equity issuance (licence term IE_t). For SP this is a negative adjustment to claw back the £2.5m they were awarded in 2010 as a result of their material under-spend during TPCR4[6]. The adjustments, expressed in 2009-10 prices, are detailed below, note these values are based on our initial proposals and subject to change in our final proposals document. Inflation has been applied in line with the methodology presented in chapter 2.

Table 1 Revenue adjustment for equity issuance in the rollover year

IE_t in the Relevant Year commencing 1 April 2012	
National Grid Electricity Transmission plc	Nil
Scottish Hydro-Electric Transmission Ltd	£3,100,000 * $RPIF_t$
SP Transmission Ltd	-£3,160,000 * $RPIF_t$

TO Incentives and TIRG

3.2. Updates to the TIRG and TII licence conditions are outside the scope of the rollover price control, and as such no licence updates have been included in this consultation. We have already communicated our decision to extend the TII framework into the rollover year and issued a consultation in October 2011 on our detailed policy proposals.[7] One of our proposals is that the allowed revenue associated with TII projects will be subsumed into the base revenue term (PR_t). As such the definition of the term $TOInc_t$, which in the existing licence represented all of the allowed revenue associated with TII has been updated to the following:

---

[6] Even without the notional equity injection its credit metrics are stronger than was assumed in the TPCR4 Final Proposals. Adjusting for inflation and the assumed return (2 years at the TPCR4 vanilla WACC of 5.05%) this equates to a £3.16m adjustment in 2009/10 prices.

[7] http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/CriticalInvestments/InvestmentIncentives/Doc

TOInct *means any adjustments to allowed transmission owner revenue reflecting changes to average asset values for Transmission Investment Incentive Projects under the provisions of special condition [x]*

The TIRG mechanism will remain largely unchanged for the rollover year, with the only change being to reflect the updated approach to RPI indexation. We are currently working with the licensees on the consequential changes to TIRG and TII base allowances in line with our updated approach to RPI indexation outlined in the previous chapter.

Incentive Mechanisms

Incentives Common to all Electricity licensees

3.3. Our general approach is to roll forward the existing incentive mechanisms. The associated licence changes are relatively minor and outlined below:

Incentive	**Approach**
Reliability	For all licensees we are simply rolling forward the parameters from the last year of TPCR4.
Innovation	As per our June 2010 Scope Decision and consultation document[8] we are leaving the innovation incentive unchanged. No updates are required to the licence.
SF_6	The structure of the SF6 incentive will remain. The SF6 targets for the rollover year will need to be updated in line with our final proposals.

3.4. It is worth noting that revenue adjustment calculated in line with the reliability and SF_6 incentives is based on performance in preceding years. For this reason, and in line with our proportionate, light touch approach to licence changes we propose to retain the historical targets / parameters within the licence.

3.5. Via the incentives licence condition each of the licensees received an allowance for certain pre-construction costs at TPCR4. Where pre-construction funding has been requested for the rollover year it has been included within the base capex allowance, and the associated term $RevApOx_t$ is no longer required.

[8] http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/ConRes/Documents1/TPCR4%20Rollover%20Scope%20Decision.pdf

Specific to the Scottish licensees

3.6. In addition to the incentives outlined in the previous section, SHETL and SP currently have two additional incentives outlined in licence condition J5. These are no longer relevant during the rollover year for the following reasons:

Incentive	**Approach**
Revenue Driver *RevDrvSP* *RevDrvSHETL*	This term awards the licensees revenue within the price control period to fund depreciation, return and an increased operational allowance where they deliver outputs via the revenue drivers, which are not funded through the base allowance. Due to our change in approach for the rollover year this revenue will be included in the base allowed revenue and this term is no longer needed. This is discussed in detail below.
Legacy Capital and Operating Expenditure Incentive Mechanisms *RCIt*	This implements a legacy arrangement from TPCR3, which expires in TPCR4. It is therefore no longer required in the rollover licence drafting.

Rationale for removing the revenue driver uplift in revenues: When setting TPCR4 a revenue driver mechanism was introduced to allow the licensees' allowances to flex in line with delivered outputs. The mechanism for National Grid resulted in an adjustment to the capex allowance at the end of the price control in advance of calculating the capex incentive. The mechanism for the Scottish licensees also realised an adjustment to the capex allowance at the end of the price control. Additionally, where the Scottish licensees incurred capex above that within their baseline allowance they were granted a return and depreciation within the price control and an allowance (equal to 1% of the additional capex) for the incremental opex resulting from their larger delivery programme. This adjustment was made for SHETL and SP through the terms *RevDrvSHETL and RevDrvSP* respectively. We consider these terms are no longer required for the rollover year for the following reasons:

1. **Return on Capex:** Our approach to revenue drivers grants the licensees revenue, on a provisional basis, to fund a return on revenue driver projects during the rollover year, any under / over recovery of return will be trued up in 2014. Therefore no additional adjustment is necessary.
2. **Adjustment to opex allowance:** The licensees' submissions on their projected opex costs were informed by their projected capex programme during the rollover year. In the light of the short duration of the TPCR4 Rollover we do not consider it necessary to make any automatic adjustment to their opex allowances.

Specific to NGET

3.7. A term ER_t was included in the TPCR4 licence to reconcile revenues from the preceding price control extension. This term is no longer required and has been removed from the licence for the TPCR4 rollover.

The impact of the revenue drivers on the capex incentive

3.8. We propose to extend the TPCR4 revenue drivers into the rollover year. This will be done as follows:

3.9. **Provide a base and provisional capex allowance:** We have split the capex allowance for the rollover year into two elements: a base capex allowance and a provisional capex allowance. The provisional capex allowance has been granted for “Revenue Driver” projects, ie all projects that, were they to complete in the rollover year, would result in an increase in the capex allowance via the revenue driver mechanisms that have been rolled forward from TPCR4. As with TPCR4 a base capex allowance has been granted to fund all other capex (both load and non-load).

3.10. A return on both elements will be included in the base revenue term (PR_t)[9]. At the end of the year all capex efficiently incurred will enter the RAV, and a regulatory return and depreciation will continue to be included in the allowed return throughout the RIIO price control.

3.11. **Calculating the capex incentive:** As described earlier, the capex incentive consists of two parts: a true up for any under / over award of return and depreciation within the rollover base revenue where capex incurred does not match the capex allowance; and an adjustment to realise the 25% sharing factor.

3.12. The table overleaf outlines how the two elements of the capex incentive calculation will be applied to the different classifications of capex.

[9] This return will be on the average incremental RAV in the year or half of the allowance. Depreciation will be awarded in the subsequent year.

Table 2 Capex incentive treatment of Base and "Revenue driver" capex allowances in the rollover

<table>
<tr><th></th><th>True up for any under / over award of return and depreciation</th><th></th><th>25% Sharing factor adjustment</th></tr>
<tr><td>Base capex allowance</td><td rowspan="2">A return on half of the capex allowance (the average incremental capex for the year) will be included in the base revenue for both base and provisional capex (defined above); as such it will be necessary to make a positive / negative revenue adjustment where actual capex is above / below the allowance for both categories.</td><td rowspan="2"></td><td>All capex incurred on non "Revenue Driver projects" that will not, when complete, result in an uplift to the capex allowance through the TPCR4 revenue driver mechanisms (as an adjustment to revenue) will be subject to the 25% sharing factor with respect to the base capex allowance.</td></tr>
<tr><td>Provisional capex allowance</td><td>It is only possible to benchmark the efficiency of the spend on "Revenue driver" projects once the project has completed and the full amount spent can be compared to the revenue driver adjustment. As such expenditure on such projects during the rollover year will only be subject to a 25% sharing factor if the project has completed before 1 April 2013 and the corresponding adjustment to the revenue driver can be calculated. If this is not the case the capex will enter the RAV un-incentivised and expenditure will be considered as part of the RIIO price control.</td></tr>
</table>

3.13. As this revenue adjustment is not scheduled to take place until the second year of the RIIO price control it would not be appropriate to include the revenue adjustment in the rollover licence. We have however presented, in draft licence form our view of how this adjustment will be included in the RIIO licence (see appendix 2). Note we will not be setting any new baselines for the revenue driver parameters for the rollover year. The baselines will instead be the final values at the end of TPCR4. For example the level of connected generation as at 31/3/2012.

NGET Balancing Services (Special Condition AA5A)

3.14. In their role as the Electricity System Operator (SO) National Grid incur both capital and operational expenditure. Their operational expenditure (opex) can be thought of as external opex and internal opex. External costs are paid to third parties to ensure the system is kept in balance; these costs are outside the scope of the rollover[10]. In line with the need for the rollover changes to be proportionate to a one year control we have simply extended the parts of the licence that award revenue to cover internal opex and capex into the rollover year.

3.15. The SO revenue associated with internal costs is currently calculated follows:

$$BX\,\mathrm{int}_t = CSOC_t + IncPayInt_t + NC_t + \mathrm{OFIC}_t + IAT_t + IONT_t$$

3.16. For the rollover year it is simpler and more appropriate to derive a number of these terms via the financial model rather than on the face of the licence. Our proposed approach is outlined below with reference to each of the revenue components.

[10] We have recently communicated our decision on how these external costs will be incentivised and a revenue stream awarded. The associated licence changes can be found at the following location: http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/Elec%20-%20Licence%20Modification%20Direction.pdf

Table 3 Treatment of components of electricity SO internal allowance in the rollover

Component	Treatment in rollover year
Aggregate of all incentivised internal costs - including return and depreciation (CSOC)[11]	***Calculation of term now takes place in financial model:*** This term awards revenue to fund both a return and depreciation on the asset base, Incentivised Internal operational expenditure (incentivised via the term IncPayInt described below). We consider it appropriate and simpler to derive the value of CSOC via the financial model and not on the face of the licence. We have therefore removed the associated formulae in the licence. The value of the term CSOC, along with the capex and incentivised opex target will be communicated at final proposals.
Incentive payments through the internal opex sharing factor (IncPayInt)	***Left unchanged for the rollover year:*** This term is the mechanism through which internal operating costs are subjected to a sharing factor against the opex allowance (defined through the term IMOT). The sharing factor is defined with an upside and a downside, IUST and IDSF (defined in schedule A). As communicated in our initial proposals this sharing factor for the rollover year will be symmetrical and will be set to 25% to ensure alignment with the external balancing costs. The associated licence changes have already been made as part of the updates to the External SO incentives scheme (page 21 of the direction referenced on the previous page). Provision is made in the TPCR4 licence to pass through a share of ad-hoc trading charges and contingency provisions as defined in the BSC from time to time; these provisions will remain in place for the rollover year.
Non Incentivised costs (NC)	These are allowances that are not subject to the operational cost incentive mechanism (IncPayInt) as described above.
Non-incentivised costs(NSOC)	***Removed:*** We propose to remove this term as all operational expenditure, with the exception of the outage changes allowance (described below) will be subject to a 25% sharing factor. An allowance will be defined within the term incentivised opex allowance (IMOT) as described above.
preparing for Betta(BI)	***Removed:*** Term was to award a return on a pre-BETTA RAV; this return will now be calculated via the financial model.
Tax(T) and pension cost (P)allowance	***Removed:*** An allowance for these items will be included in the base revenue term CSOC which will be derived via the financial model. These terms are no longer required in the rollover licence.
outage changes (ON)	***Left unchanged for the rollover year:*** allowance for outage changes we propose to leave this unchanged for the rollover year.
Costs relating to the offshore electricity transmission system (OFIC)	***Removed:*** Costs associated with setting up the offshore transmission network. These costs are now set via an ex-ante allowance, and will be included in the value incentivised opex allowance (IMOT). This is in line with our October consultation. This term is therefore no longer required for the rollover year.
Income adjusting event term (IAT)	***Left unchanged for the rollover year:*** This term allows the Authority to direct an income adjusting event. This provision will remain for the rollover year.
Income adjusting event term –	***Left unchanged for the rollover year:*** This term allows the Authority to direct an income adjusting event when the outage costs

[11] Though not a direct revenue adjustment this term also describes how the RAV will be incremented in line with capex incentive. As with the TOs capex incurred by the SO is subject to a 25% sharing factor. Unlike the TOs, the adjustment is made to the RAV rather than as a revenue adjustment. As outlined in our initial proposals the sharing factor will remain at 25% for the rollover year.

outages (IONT)	are materially different (£300k) from the allowance.

4. NGG

Chapter Summary

This chapter outlines the licence conditions we are proposing to modify or introduce in order to give effect to our TPCR4 Rollover proposals for NGG. It summaries what each of the relevant conditions currently does and explains why the proposed changes are required.

Question 3: We invite stakeholders to comment on the proposed licence changes outlined in chapter 4.

4.1. Our proposals for the changes to NGG's licence are set out in the initial proposals that were published in August 2011. We will set out our final proposals in November 2011. This chapter explains our approach to the proposed licence drafting for the TPCR4 Rollover.

Logged up costs

4.2. In setting the TPCR4 price control, we allowed the licensees to log up costs in a specific number of categories. We applied this approach to costs where there was a significant amount of uncertainty as it avoided us having to project these costs in advance. In order to protect consumers from inefficient spend these logged up costs will be subject to an ex-post efficiency review at the end of the current price control.[12] In the Initial Proposals for setting the rollover price control, we considered the level of uncertainty to be limited for a one-year period, and proposed to not allow costs to log up during 2012/13.

4.3. In our subsequent TPCR4 rollover supplementary consultation[13] we indicated that we also consider it appropriate to continue to allow NGG to log up costs associated with claims and compensation for loss of land use due to the installation of gas transmission assets[14] (Quarry and Loss development). These costs are uncertain, and setting an ex-ante allowance would expose NGG to potential gains or losses due to events outside of their control.

4.4. To protect consumers from inefficient spend in this area NGG will continue to have a licence obligation to challenge these claims as far as is reasonable, and revenue will only be awarded to recompense these costs following a full efficiency

[12] As communicated in our initial proposals efficient investment will enter the RAV on 1 April 2013. http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/110802TPCR4RolloverIP.pdf
[13] Transmission Price Control Review (TPCR4) rollover supplementary consultation, 7 October 2011 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/111007_TPCR4RO_Interimconsultation.pdf
[14] This may include: loss of crop and drainage; loss of land development eg housing, quarrying etc; sterilised minerals; landfill and tipping; and power generation.

review. The logged up costs will undergo a full efficiency review before entering the RAV on 1 April 2013 on an NPV neutral basis.

Garton SO Revenue

4.5. For incremental signals received before April 2007, NGG receives SO revenue for five incentivised years, and following this receives a fixed rate of return until the end of the current price control. Additionally, NGG's TO revenue is adjusted to account for the difference between actual and deemed capex. When the next price control starts, NGG's SO revenues should cease, and the investment remunerated through NGG's TO revenue[15].

4.6. A signal for incremental entry capacity at Garton was received at the February 2004 auction. This was for 420 GWh/d of capacity to be released from October 2006 (month 55 in the licence). This provides NGG with the following SO revenues:

SO1	Oct-06 to Sep-11: auction revenues, subject to cap and collar of 12.25% and 5.25% RoR on the deemed capex (deemed capex is the Unit Cost Allowance x capacity)
SO2	Oct-11 to Mar-12: fixed RoR of 6.25% on deemed capex

This should also provide NGG with the following TO revenues:

TO1	Apr-07 to Mar-12: TO revenue on TO RAV (actual efficient capex – deemed capex)[16]
TO2	Apr-12 onwards: TO revenue on TO RAV (actual efficient capex

4.7. The SO2 revenue stream does not automatically get switched off on 31 March 2012 in the licence. The SO2 revenue stream is provided by the SOREVIBEC term in the licence[17]. This is defined such that it is switched on when both of the following conditions are met:

- We are at a point 5 years after contractual deliver of the incremental capacity – in Garton's case this would be after September 2011
- The incremental capacity is included in the NTS SO baseline entry capacity[18]

[15] For more detail on these arrangements, please see Appendix 5 of our April 2011 document: 'TPCR4 rollover policy update and initial analysis of business plans' http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4Roll-over/Documents1/TPCR4roll.pdf

[16] NGG note that the TO RAV adjustment of actual efficient capex less deemed capex was not made at April 2007 and so this revenue stream did not occur.

[17] See paragraph 14(5)(a) of Annex A to Special Condition C8D Part C Part 2

[18] This is defined in Annex A to Special Condition C8D Part B as the 'initial NTS SO baseline entry capacity and that terminal's permanent obligated incremental capacity for which the first day to which such

This does not have an end point and so licence amendments need to be made in order to switch this SO2 revenue off. Otherwise, NGG will continue to earn this revenue beyond the intended end point which would need to be 31 March 2012 in the case of Garton as per our June 2003 document on new entry terminals[19]. Licence amendments need to be made in order to switch this SO2 revenue off otherwise NGG will continue to earn this revenue beyond March 2012. Garton will contribute to the TO allowed revenue.

4.8. We will undertake a similar exercise for Barton Stacey, although the Unit Cost Allowance and the capex was zero for Barton Stacey. Like Garton this will be to ensure that the Barton Stacey revenue and obligations are classified as TO and not SO. We will make amendments in Special Condition C8D[20].

Permits

4.9. NGG is incentivised to deliver capacity ahead of the default investment lead times via the permit scheme. The amount that can be earned from the scheme is capped at £36 million and £3 million for entry and exit permits respectively. Our provisionally preferred approach is that NGG receives the incentive payout in 2012-13 and that the permit scheme is extended for one year on a pro-rata basis.

4.10. The NTS licence will be amended to reflect these changes Special Condition C8C[21].

capacity relates has occurred five or more years previously' but also by equation in paragraph 14(5)(g) of Annex A to Special Condition C8D Part C Part 2.

[19] New entry terminals to Transco's National Transmission System: Ofgem's views on Transco's proposals and Explanatory notes to accompany the section 23 notice of proposed modifications to Transco's gas transporter licence; June 2003 http://www.ofgem.gov.uk/Networks/ad/Documents1/3807_New_entry_terminals_final.pdf

[20] NTS gas entry incentives, costs and revenues, PART C – Capacity release obligations 9(c) table 7 and (d) table 8.

[21] NTS System Operation Activity Revenue Restriction

Appendices

Index

Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. (In particular, we would like to hear from xxxx. If appropriate)

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 18th November and should be sent to:

Gareth Walsh
Senior Manager, Transmission and Governance
Transmission
9 Millbank
London
SW1P 3GE
Tel: 0207 901 1867

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

Question 1: We invite stakeholders to comment on the proposed licence changes outlined in chapter 2.

Question 2: We invite stakeholders to comment on the proposed licence changes outlined in chapter 3.

Question 3: We invite stakeholders to comment on the proposed licence changes outlined in chapter 4.

Appendix 2 – Updated RPI methodology

This appendix outlines the formula for calculating the RPI adjustment as outlined in chapter 1

$RPIF_t$ is the price index adjustment for the relevant year t, and in the relevant year commencing 1 April 2009 shall take the value of 1 and in each subsequent relevant year shall be derived from the following formula:

$$RPIF_t = RPIA_{t-2} \text{ x } (1+GRPIF_{t-1,s}) \text{ x } (1+GRPIF_{t,s})$$

where: $RPIA_t = RPI_t/RPI_{2009\text{-}10}$

where:

RPI_t means the arithmetic average of the Retail Prices Index published or determined with respect to each of the twelve months from April to March in Formula Year t where Retail Prices Index Forecast Growth Rate means:

(a) the growth rate as defined as the “New forecasts (marked *)” in the HM Treasury “Forecasts for the UK Economy” publication, published in the November of each year; or

(b) if in any year the HM Treasury does not publish that growth rate, or changes the basis for calculating that growth rate, the Authority will, after consultation with the licensees, determine an appropriate index to be used.

$RPI_{2009\text{-}10}$ means the arithmetic average of the Retail Prices Index published or determined with respect to each of the twelve months from April 2009 to March 2010 where:

$$GRPIF_{t}, = 0.75*GRPIF_{c}, + 0.25*GRPIF_{c+1}$$

$$GRPIF_{t-1,s} = 0.75*GRPIF_{c-1} + 0.25*GRPIF_{c},)$$

where:

$GRPIF_c$ means the Retail Prices Index Forecast Growth Rate for the calendar year c and where c is the calendar year 2012. This information is taken from the

November 2011 edition of the HM Treasury publication "Forecasts for the UK Economy".

Appendix 3 – Capex incentive calculation

This appendix details how the equation that will calculate the capex incentive for the electricity licensees described in chapter 3 is derived.

The adjustment in line with this calculation will be made to revenue in 2014-15. For that reason we must inflate the result of the calculation to account for inflation in 2013-14 and increase it by the allowed return granted as part of the RIIO price control to ensure this deferral of revenue adjustment is made on an NPV neutral basis. For simplicity this adjustment is applied once the component parts of the adjustment have been made.

In calculating the revenue adjustment it is simplest to consider it as consisting of three separate parts:

1. A True up for any under / over award of return and depreciation
2. Calculating the 25% sharing factor for capex funded through the base capex allowance.
3. Where appropriate calculating the 25% sharing factor for capex funded through the provisional capex allowance.

Before going through the detailed calculations it is necessary to define a number of terms:

RevAdj This is the overall adjustment to revenue to realise the capex incentive from the rollover year. This is calculated as per the formulae below.

CIR means the proportion of under or overspend against the capital expenditure allowance for the relevant year n that is borne by the licensee within the price control. *For the rollover year this will be half of the rollover allowed return.*

PVFRO means the present value adjustment factor for the rollover year, this is equal to the rollover allowed return.

PVFRIIO means the present value adjustment factor for the RIIO price control, this is equal to the rollover allowed return.

ALB means the Base capex allowance.

ALP means the provisional allowance granted for projects that if they complete in the rollover year will result in an increase in the term LVN.

LVWIP means the adjustment in the capital expenditure allowance relative to the base capital expenditure allowance (**ALB**) in respect of works carried out by the licensee which would otherwise have resulted in an increase in the capex allowance via the term LVN. Defined in 2009-10 values.

WIP_i means the adjustment in the capital expenditure allowance that was made as part of TPCR4 for project 'i' as it was classified as Work in Progress where i represents an individual project. Defined in 2009-10 values.

ACT means the total capex incurred on all projects defined in 2009-10 values.

RPIF Is the projected level of inflation [as described in chapter 1 and defined in appendix 2].

RetAdj means the total revenue adjustment to award / clawback return and depreciation as defined below.

SFAdj means the total revenue adjustment to realise the 25% sharing factor.

LVNG means the Gross uplift to the capital allowance in the rollover year as a result of the revenue drivers, in line with the methodology outlined in special condition X of the TPCR4 transmission licence, excluding WIP in place at the end of TPCR4. Defined in 2009-10 prices.

LVNN means the Net uplift to the capital allowance in the rollover year as a result of the revenue drivers, accounting for capex that entered the RAV in TPCR4 as WIP, as defined below:

$Complete_i$ for each "Revenue Driver project", defined below. If the project completed before > April 2013 $complete_i = 1$; else $complete_i = 0$ where i represents an individual project.

Revenue Driver project is defined as a project which were it to complete within TPCR4 would have resulted in an adjustment to the term LV_n

<u>Derivation of terms</u>

RevAdj = $(RETAdj + SFAdj) * PVFRIIO * RPIF_t$

Where:

Adjustment to clawback / grant additional return and depreciation

$$RETAdj = \left[CIR \right] \times PVFRO \times \left(ACT - ALB - ALP \right)$$

Adjustment to account for the 25% capex incentive

$$SFAdj = (0.25 * PFVRO \times ((ALB + LVNN) - (ACT - LVWIP))$$

Net uplift in capital allowance accounting for work in progress

$$LVNN = LVNG - \sum_i (complete_i \times WIP_i)$$

Appendix 4 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk