



Transmission Network Licensees,
Providers of finance, Consumer
Groups, and, other interested
parties

*Promoting choice and value for
all gas and electricity customers*

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Date: 29 March 2012

Dear colleague,

Transmission Annual Report for 2010/11

In previous years we have produced an annual report on the transmission licensees' financial performance. The report compared performance against earlier years and against price control allowances. Given that we are in the middle of the RII0-T1 price control review and therefore more focus will be on forecasts of future performance rather than historical, we have decided this year to publish a shorter report in the form of a letter.

The report focuses on the key issues that we believe stakeholders will be interested in, financial performance against allowances, and reasons for any divergence. It covers both the Transmission Owners (TOs) and System Operators (SOs). Unless stated otherwise all figures are quoted in 2010/11 prices.

This report concentrates on the financial performance of the transmission licensees. National Grid produces an annual Transmission System Performance Report on the electricity transmission system performance including interconnectors¹. The performance report shows system availability, system security and quality of service in total and for each of the TOs. The performance report will also include offshore transmission as this develops.

Allowed Revenue

The table below shows a comparison of total allowed revenue figures for each of the transmission licensees for 2009-10 and 2010-11. Please note that allowed revenue for Scottish Hydro Electric Transmission Ltd. (SHETL) 2009-10 has been restated for Transmission Investment for Renewable Generation (TIRG) and a correction factor. Overall SHETL revenue rose in 2010-11 due mainly to increased business rates and revenues allowed under the Transmission Investment Incentive (TII) scheme. The National Grid Electricity Transmission (NGET) System Operator (SO) variance reflects a reduction in year on year balancing costs.

¹ See <http://www.nationalgrid.com/uk/Electricity/Info/performance>

Table 1: Comparison of Total Allowed Revenue (nominal prices)

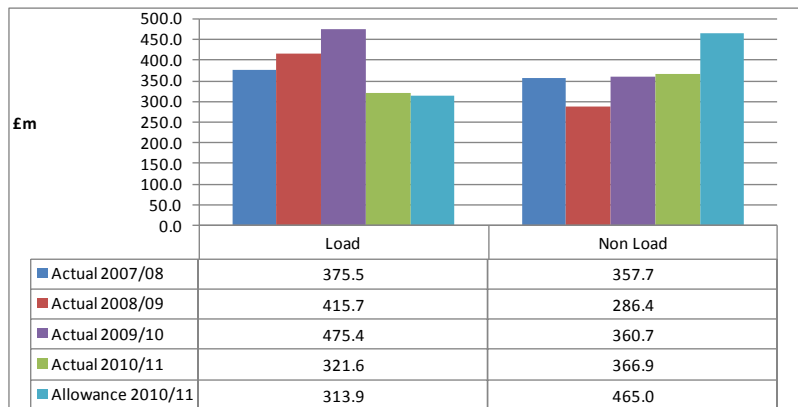
Comparison of Total Allowed Revenue (nominal prices)				
Company	2010-11 £m	2009-10 £m	Variance	Variance %
National Grid Electricity TO	1590.8	1511.5	79.3	5.0
National Grid Electricity SO	699.9	790.7	-90.8	-13.0
National Grid Gas TO	586.4	604.5	-18.1	-3.1
National Grid Gas SO	424.4	426.8	-2.4	-0.6
Scottish Hydro Electric Transmission Ltd	80.1	67.7	12.4	15.5
Scottish Power Transmission Ltd	219.5	198.4	21.1	9.6

Transmission Owners (TOs)

TO Capital Expenditure (Baselines)

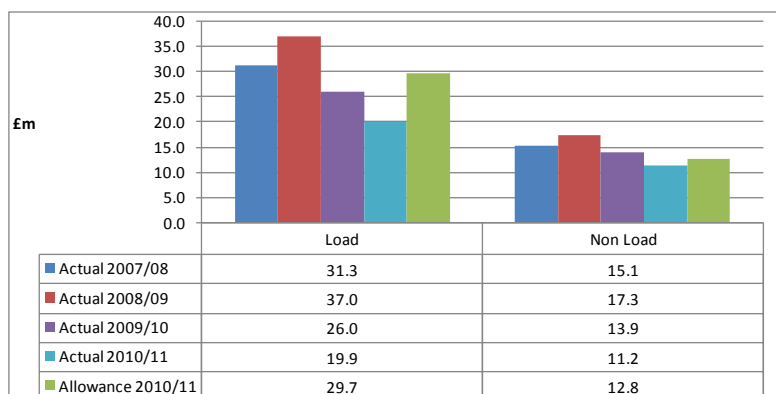
This section discusses the individual TO’s baseline capital expenditure (capex) performance against allowances. The baseline is before any impact of revenue drivers and net of customer contributions.

Figure 1: National Grid Electricity Transmission (NGET) Baseline Capital Expenditure



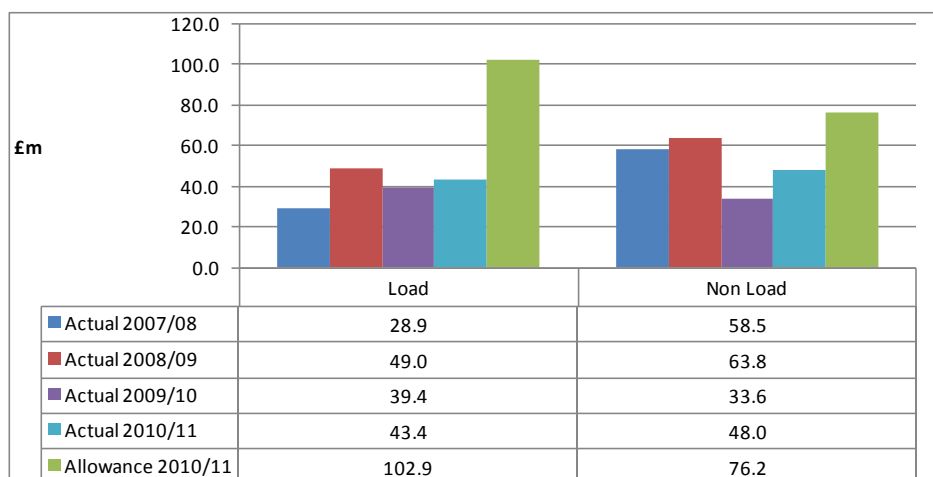
NGET’s capital expenditure in total was £688.5m, 17.6% lower than in 2009/10, and 11.6% lower than allowances for 2010/11. The reductions in load related expenditure were due to reduced spend on demand connections and general non reactive scheme infrastructure. Non load related spend increased due to the rise in expenditure on underground cables and overhead lines, but was still 21.1% lower than the allowance.

Figure 2: Scottish Hydro Electric Transmission Ltd (SHETL) Baseline Capital Expenditure



SHETL’s overall capex of £31.1m was 22.1% lower than spend in 2009/10 and 26.8% lower than the allowances. Load related expenditure was higher than the figure for 2009/10, but this was more than offset by increases in customer contributions. Non load related expenditure was lower than in 2009/10 due to reduction in spend on overhead lines.

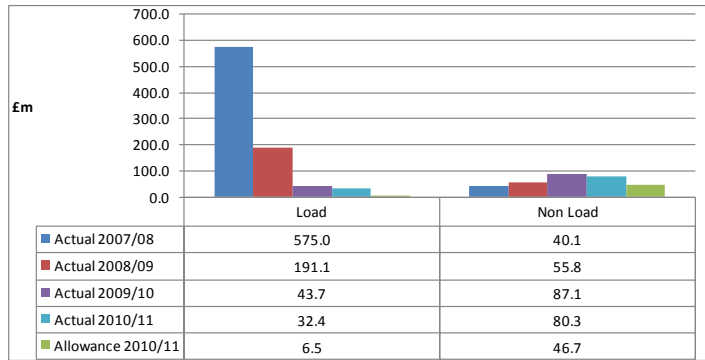
Figure 3: Scottish Power Transmission Ltd (SPTL) Baseline Capital Expenditure



NB: The figures are calculated after adjustment for related party margins and excess capitalisation

SPTL’s total capital expenditure after adjustment was £91.4m, 25.2% higher than in 2009/10 and 49.0% lower than the 2010/11 allowance. The major cause of the load variance is the implementation of more cost effective design solutions to improve the transfer capability across the boundary between South of Scotland and England. Non load related expenditure was 42.8% higher than 2009/10 but below the allowance. The increase in expenditure was due to higher levels of activity replacing gas compression cables, transformers and switchgear and a higher number of plant/cable fault repairs.

Figure 4: National Grid Gas (NGG) Baseline Capital Expenditure



NGG total capital expenditure was £112.7m, 13.8% lower than 2009/10, but significantly over the allowance of £53.2m. Load related expenditure was above allowances due to continuing expenditure on the Milford Haven pipeline project, which was expected to be completed. Non load related expenditure was also above allowances due to spend on emissions and asset health. In previous years there were under spends in these two areas.

Incentivised Capital Expenditure

The capex incentive was introduced in TPCR4 to share the impact of over or under spends on capex between customers and shareholders. The incentive means that 25% of the net benefit from under spends will be retained by the licensee. Conversely 25% of any overspend is borne by the licensee. Currently the Scottish TOs are both showing cumulative under spends against allowances, where as the National Grid TOs are showing over spends.

The table below shows the calculation of incentivised capex both for 2010/11 and a cumulative position from 2007/08 to date. The first part of the table is simply the total capex compared with the allowances. The second shows the adjustments made to both actual spend and allowances to come to a value for incentivised capex. The third section shows a cumulative position for incentivised capex.

NB. A revenue driver adjustment for SHETL and SPTL has not been included in these figures, but will be made at the end of TPCR4.

Table 2: Incentivised Capex

Comparison of Actual Capex with Total Allowances (£m)				
	NGET TO	SHETL TO	SPT TO	NGG TO
Load Related	321.6	19.9	43.4	32.4
Non Load Related	366.9	11.2	59.3	80.3
Pension Deficit	10.4			
Subtotal for Provisional RAV (a)	698.8	31.1	102.7	112.7
Logged up capex	32.7	0.9	3.2	0.6
Incremental capex				77.1
TIRG	31.3	30.6	13.3	
TO Incentives	113.8	38.7	5.2	
Regulatory WIP	125.5			
Total Actual Expenditure	1,002.0	101.4	124.4	190.3
Load Allowance (before revenue driver adjustment)	313.9	29.7	102.9	6.5
Non Load Allowance	465.0	12.8	76.2	46.7
Pension Deficit	10.4			
Total 2010/11 Final Proposals (b)	789.2	42.5	179.1	53.2

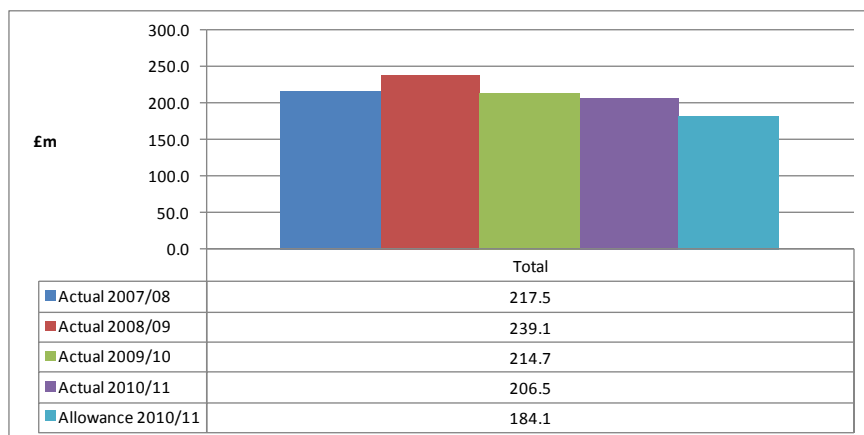
Comparison of Incentivised Capex with Incentivised Allowances (£m)				
	NGET TO	SHETL TO	SPT TO	NGG TO
Total Capex (a)	698.8	31.1	102.7	112.7
Less capitalised pensions	(6.2)	(1.0)	(1.3)	
Less net load related sole use	(14.1)	1.0	(15.3)	
Less Pension Deficit	(10.4)			
Total Actual Incentivised Capex	668.1	31.2	86.0	112.7
Total Capex Allowance (b)	789.2	42.5	179.1	53.2
Revenue driver adjustment	155.5			
Less capitalised pensions	(4.5)	(1.0)	(0.9)	
Less net load related sole use	(35.7)	(1.8)	(3.6)	
Less Pension Deficit	(10.4)			
Total Final Proposal Incentivised Capex	894.1	39.7	174.6	53.2
Incentivised Capex Over / (Under Spend)	(226.0)	(8.5)	(88.6)	59.5
As a Percentage	(25.3%)	(21.4%)	(50.7%)	111.7%

Cumulative Incentivised Capex 2007/08 to 2010/11				
	NGET TO	SHETL TO	SPT TO	NGG TO
Actual Incentivised Capex	2,708.5	145.0	331.7	1,105.3
Final Proposal Incentivised Capex	2,792.0	163.4	546.5	942.8
Incentivised Capex Over / (Under Spend)	(83.5)	(18.5)	(214.9)	162.5
As a Percentage	(3.0%)	(11.3%)	(39.3%)	17.2%

TO Controllable Operating Costs

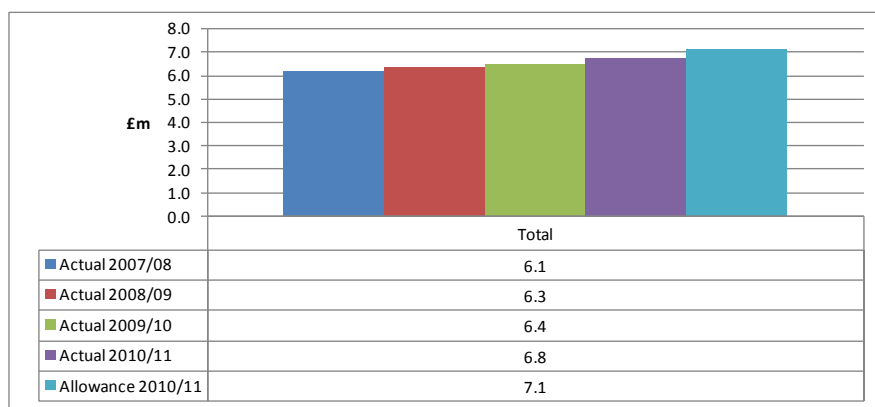
This section discusses the individual TO's controllable operating cost (Opex) performance against allowances. Controllable Opex includes all non operational capex and excludes net movements in provisions and costs not within the licensee's control such as the Ofgem licence fee and network rates. Non operational capex is capital spent on items other than network assets such as computers and vehicles, and is included in opex due to the short life (usually less than 5 years) of such assets.

Figure 5: NGET Controllable Opex Performance against allowances



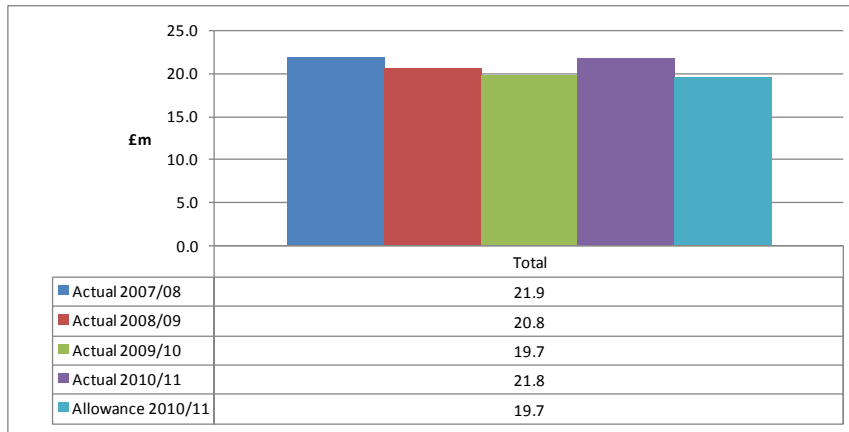
NGET’s controllable operating costs were £206.5m, 3.8% lower than in 2009/10 but still 12.2% above the allowance. The reduction in opex was mainly due to savings in shared services functions such as procurement and insurance, and savings from the outsourcing of various functions. Non operational capex was above expenditure in 2009/10 but lower than the allowance. Most of the increase in expenditure was on small IT system developments around work management and shared services.

Figure 6: SHETL Controllable Opex Performance against allowances



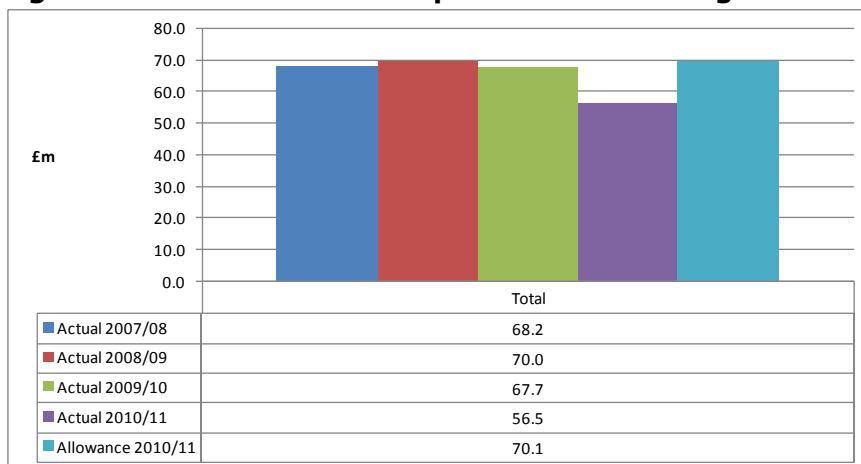
SHETL’s controllable operating costs were marginally above those in 2009/10, but lower than the allowance. The reason for the under spend was that the allowance anticipated that large capital projects (e.g. Beaulieu Denny) would come on stream at the end of the price control, leading to increased opex. There have been delays in these due to planning consents and enquiries, hence the under spend against allowances.

Figure 7: SPTL Controllable Opex Performance against allowances



SPTL’s controllable operating costs were £21.8m, after reclassifying £5.4m of capex as opex. This is 10.7% higher than 2009/10 and also 10.7% above allowances. The increase in spend was due to increases in engineering indirect costs as capex increases and also a slight increase in tower painting costs.

Figure 8: NGG Controllable Opex Performance against allowances



NGG controllable operating costs were 19.4% lower than the allowance and 16.5% lower than expenditure in 2009/10. This lower spend was due to the receipt of insurance proceeds following incidents at the Wormington compressor site and efficiency savings within the business. These reductions were partially offset by increases in gas technical drawing costs.

Logged up Capex and Innovation Funding Initiatives (IFI)

In TPCR4 we introduced a mechanism by which licensees could “log up” certain capital costs; they would receive income on efficiently incurred costs at the start of the next price control (RIIO-T1), and the costs would also be added to the RAV at the same time. The table below summarises the cumulative logged up costs (2007/08 to 2010/11) for each licensee. BT 21st Century Network (BT21CN) costs are those incurred by TOs to replace tele-protection services that will be incompatible with BTs new network platform when it is introduced. Quarry and loss development costs relate to the physical diversion of pipelines.

Table 4: Logged Up Capex

	NGET	SHETL	SPTL	NGG
BT21CN Costs			11.0	
Cable Tunnels	41.4			
Quarry & Loss Development Claims				3.0
Milford Haven Pipeline Project				90.2
Other	57.4	1.2	6.9	80.3
Total Logging Up Capex	98.9	1.2	17.9	173.5

The following table shows the amount spent by TOs on IFI projects from 2007/8 to 2010/11, 80% of such expenditure is offset by allowed revenue up to a cap of 0.5 per cent of turnover or £0.5m whichever is the higher. These are primarily research and development projects paid for by the licensee and undertaken by external parties (e.g. universities).

Table 4: Cumulative Expenditure on IFI

Cumulative Expenditure to 2010/11	NGET TO	SHETL TO	SPTL TO	NGG TO
IFI Expenditure	24.0	1.9	0.5	9.7
80% allowed	19.2	1.5	0.4	7.8

TO Provisional Regulatory Asset Value (RAV)

The provisional RAV has been rolled forward in accordance with the licence conditions, based on capex to date. The figures have been prepared using the actual costs as reported annually but remain provisional pending an efficiency review of capital schemes to be carried out as part of the RIIO-T1 process.

Table 5: Provisional TO RAV

2009-10 prices £m	Opening RAV 1st April 2010	Opening Adjustment	Restated Opening Balances	Net Additions	Depreciation	Closing RAV 31st March 2011
NGET	7,016	2	7,018	656	(475)	7,200
SHTL	433	0	433	33	(23)	444
SPTL	868	8	876	87	(65)	899
NGG	4,023	(9)	4,014	106	(129)	3,990
Total	12,340	1	12,341	883	(691)	12,533

The opening adjustments from the values shown in the TPCR4 Rollover: Final Proposals document (162/11) relate to minor clarifications of data from the companies. There is some expenditure for the transmission operators that is not yet reflected in the RAV values at 31 March 2011. For clarity this expenditure (subject to efficiency assessment as appropriate) will be added to RAV on the following basis:

- Security costs, Transmission Investment Incentive (TII) expenditure and Work in progress (WIP) will be added to the RAV at the start of the rollover year.
- Logging up – will be added to RAV at the start of RIIO-T1.
- Transmission Investment for Renewable Generation (TIRG) – will be added to the RAV following the completion of the five year post completion incentive period in accordance the scheme rules.
- Revenue driver expenditure for NGG which is remunerated under specific separate mechanisms will be added to RAV over the next few years.

The provisional values are summarised below:

Table 6: Costs Not Yet in RAV

2009-10 prices £m	Security costs	TII	WIP	Items treated as logged up	TIRG	Revenue Driver	Total
NGET	55	121	202	39	102	0	520
SHTL	1	45	0	0	45	0	91
SPTL	7	5	0	11	109	0	131
NGG	77	0	0	91	0	403	572
Total	140	171	202	141	256	403	1,314

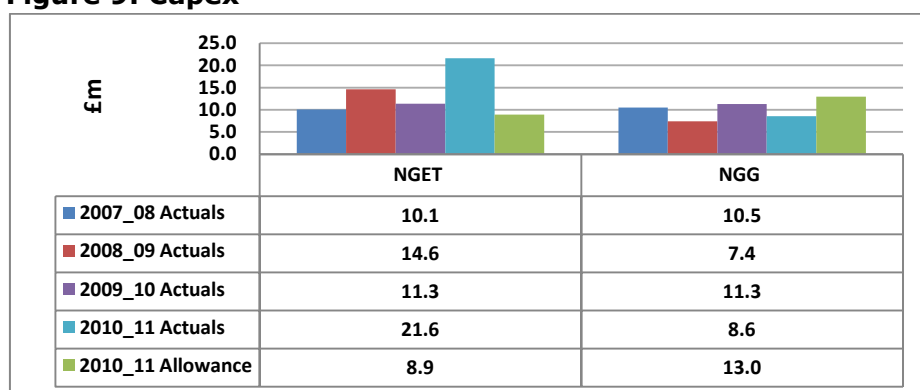
System Operators (SOs) – Internal Costs only

Total SO costs are made up of external and internal costs. External costs are those incurred in the real time system balancing and ensuring systems stability and security. Internal costs include staff and information technology (IT) systems to enable the external balancing system to operate. We only consider internal costs in this section as external costs are subject to separate regulatory treatment.

SO Internal Capital Expenditure

This section shows the individual SO's capital expenditure performance against allowances.

Figure 9: Capex



NB. The NGG capex is after adjustment for Xoserve expenditure

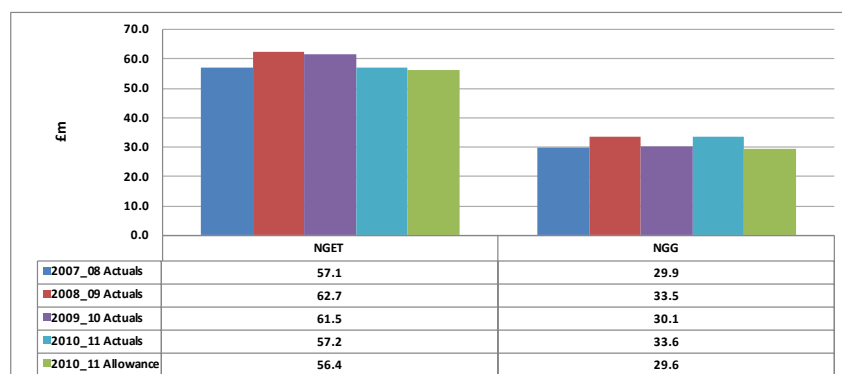
NGET's capex was £21.6m, 142.7% above the allowance and 91.2% higher than expenditure in 2009/10. The increased expenditure was as a result of IT investment on the Energy Balancing System (EBS) which replaces the Balancing Mechanism (BM) system and capex on the control centre and property infrastructure. NGG's capex was £8.6m, 33.8% below the allowance and 23.9% below expenditure in 2009/10. This was primarily due to lower IT expenditure on the integrated gas management system (iGMS) as the upgrade comes to an end.

SO Internal Controllable Operating Costs

This section discusses the individual SO's controllable operating cost performance against allowances. Controllable Opex excludes net movements in provisions and costs not within

the licensee's control. Unlike TOs there is no non operational capex included in these figures.

Figure 10: Controllable Opex



NGET's controllable costs were £57.2m, only 1.4% above the allowance, and 7% lower than in 2009/10. Costs were higher than allowances due to increased levels of critical IT support, incremental market facilitation costs, and changing workloads offsetting efficiencies. Costs reduced in the year due to one-off reorganisation costs in 2009/10. NGG's controllable costs were £33.6m, 13.5% higher than the allowance and 11.6% above expenditure in 2009/10.

SO Provisional RAV

The table below shows the provisional RAV for the internal SO.

Table 7: SO Provisional RAV

2009-10 prices £m	Opening RAV 1st April 2010	Net Additions	Depreciation	Closing RAV 31st March
NGET	34	18	(6)	45
NGG	24	9	(4)	30
Total	59	27	(10)	75

The opening values for NGET and NGG SO have been restated (with the agreement of NGET and NGG) to exclude those additions prior to 2008 which will be fully written down by the end of the rollover year. NGET and NGG receive the full depreciation allowance over these years and the differences are therefore purely presentational.

Return on Regulatory Equity (RoRE)

The RoRE is a measure of performance, showing the estimated financial return achieved compared to the cost of equity originally allowed in the price control settlement. The calculation compares the baseline cost of equity assumed at the price control to the estimated returns on regulatory equity² earned by the relevant TOs. It assumes generic

² Regulatory equity is measured as the share of the Regulatory Asset value funded by notional equity (40% in the case of TPCR4).

financing arrangements (ie cost of debt and gearing levels). We have assumed that all companies have managed to outperform our cost of debt assumption and this has contributed 0.48% to the RoRE. There is however no direct read across to returns that companies report in their accounts since the methodology for RoRE recognises some gains that companies will only see over time.

The approach to this calculation has been refined from that issued with the RIIO-T1 and GD1 Strategy Decision paper. We recognise that the impacts of certain expenditure (e.g. gas revenue drivers) and the contribution from the SOs are not reflected. The results additionally represent our provisional view of the overall performance, subject to the caveats mentioned above, and pending our assessment of capex efficiency which will be carried out during the RIIO-T1 review . We will continue to work together with the TOs to further refine the approach for the RIIO-T1 price control.

SHETL has shown an overall return calculated at 9.07%. This is due in part (0.64%) to underspend of allowances under the TII scheme. We expect most of the impact of this to reverse as delayed schemes catch up. Additionally the company has under-spent against its capex allowances (c0.42%) (see figure 7 above) and has benefitted from our cost of debt assumption.

SPTL has shown an overall return of 10.43%. This is primarily due (2.03%) to under spend of its capex allowances (see figure 8 above). We expect some of the impact of this to reverse in the final year of TPCR4. Additionally the company has under-spent against allowances under the TIRG scheme (0.64%) and has benefitted from our cost of debt assumption.

NGG has shown an overall return of 7.41% (although as mentioned above this excludes any contribution from the SO and in particular gas revenue driver contribution). The main elements are an over-spend of capex allowances (-0.42%) offset by under spend of opex (0.23%) and our cost of debt assumption.

NGET has shown an overall return of 7.60% (although as mentioned above this excludes any contribution from the SO). The main factors here are an over-spend of opex allowances (-0.68%) offset by underspend of capex (0.32%) and our cost of debt assumption.

Comments

We would like to receive any comments from stakeholders on this letter. We are particularly interested to understand if stakeholders find the report helpful and what other information we should include in the report in future years. Comments and questions on this report should addressed to Martin Rodgers, martin.rodgers@ofgem.gov.uk

Yours faithfully,

Adam Cooper
Head of Transmission Cost and Outputs