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Dear Andrew,

Response to Evaluation of Tender Round 1 Benefits Report

National Grid welcomes the publication of, and the opportunity to comment upon, the report prepared by CEPA and BDO providing an economic evaluation of the offshore transmission owner (OFTO) regime applied to the tender round one (TR1) projects. This response is made on a non-confidential basis on behalf of National Grid Electricity Transmission (NGET).

National Grid owns and maintains the high-voltage electricity network in England and Wales and operates the National Electricity Transmission System in Great Britain, connecting people to the energy they need and balancing supply with demand on a minute by minute basis.

National Grid has a role in enabling the connection of offshore generators and integrating offshore transmission assets into the GB system, and has worked closely with DECC and Ofgem to support the development of the OFTO regime and the processes associated with the regime.

National Grid welcomes any benefits to consumers that TR1 has brought and likewise welcomes any initiatives that will drive further consumer value in the future. When evaluating the benefits of TR1 in considering future Tender Rounds, the one off nature of some of the savings and the need to ensure the overall co-ordination of the network mean that the industry will need to consider carefully what solutions are likely to provide the greatest long term benefits to consumers. This is a complex area that requires input from a wide variety of stakeholders and one which we are committed to support and provide input to.

National Grid recognises that in the context of the TR1 OFTO projects the introduction of the competitive asset based licensing regime has attracted new sources of finance to the energy market in Great Britain and has brought advantages in terms of identifying operating costs closer to the efficiency frontier faster than other regimes may have achieved. While it is difficult to estimate how quickly similar operational arrangements between the network owner and generator would have emerged under counterfactuals 3 – 5, we agree that the OFTO approach applied to the TR1 projects made this learning faster than would have occurred otherwise.

However, we have found some difficulty in understanding the assessment that the OFTO regime delivers operational expenditure benefits when compared to the merchant approaches identified in counterfactuals 1 and 2. There is no clear evidence presented as to why a generator providing maintenance services to its in-house TO business would result in higher overall costs for consumers than when they provide these services to third party OFTO's.

Irrespective of the challenge above, now that this learning has occurred it is likely that the benefits in future rounds would be much smaller against all counterfactuals. While there is some scope for new entrants to continue to bring further innovative approaches and access finance that may be inaccessible to existing TOs, it would appear from the consultant's analysis that the benefits, excluding tax benefits, may be less than the regime bid costs.

We have excluded tax benefits from this assessment as there is no explanation within the report of how these arise (especially at the high levels quoted) and we therefore cannot understand how they are calculated. We do not envisage that the additional benefits relate to capital allowances as any such benefits would apply equally across all counterfactuals. We would therefore be keen to understand how these additional tax benefits arise.

We would also be keen to understand if the claimed tax benefits take into account the fact that government will be likely to respond to the tax "shortfall" by either raising additional tax via an alternative route, or by operating on a smaller budget? If this is not the case, from a social welfare perspective the "tax benefit" claimed for electricity consumers may potentially be overstated as this benefit may be offset by consumers paying the additional burden as taxpayers.

The OFTO approach has helped define the risk profile of the TR1 assets such that it is different to that under an onshore TO led regime with additional offshore assets (counterfactual 3). Due to the change in risk profile, it is not possible to isolate the difference in financing costs observed in the OFTO regime and that which arise for a transmission 'project portfolio'. Moreover, the consultant's assessment has also not identified the extent to which risks associated with managing these assets under the OFTO regime has been shifted to consumers compared to where they would lie if they had been built by an onshore transmission owner.

As we move towards integrated energy networks within Europe the potential ongoing benefits of asset by asset competition must be balanced against the potential benefits of ensuring there is suitable overall coordination of the network. Given the highly capital intensive nature of networks, there are significant potential benefits from optimising network developments such that offshore generators and interconnectors share facilities and interconnect to the onshore system in ways that avoid the amenity impacts of new onshore overhead lines. These solutions require flexibility in the use of offshore assets as the network develops. Such flexibility is currently missing from the 20 year contracts currently being set in the OFTO arrangements. National Grid is aware of at least one case where minor customer changes to the OFTO contract led to significant transaction costs which act as a barrier to network development and innovation. Given these issues we continue to support Ofgem's review and ongoing development of the regulatory arrangements under their integrated transmission planning and regulation project (ITPR).

In summary, the CEPA and BDO analysis provides some support to Ofgem's earlier savings estimate; however it identifies reasons why such savings may be unlikely to arise again against price control counterfactuals in the future. The report is also silent on the important issue of coordination and co-optimisation of interacting network developments in the future which is likely to be an increasingly important factor in reducing the costs that consumers will ultimately need to pay.

Yours sincerely,

[By e-mail]

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