National Grid Transco

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

David Halldearn
BETTA Project
Office of Gas and Electricity Markets (Ofgem)
9 Millbank
London
SW1P 3GE

Tim Tutton
UK Director of Regulation

tim.tutton@ngtuk.com
Direct tel +44 (0)1926 653140
Direct fax +44 (0)1926 656520

31 March 2004

Dear David

Consultation on form of transmission owner revenue restrictions and consequential effects on NGC's revenue restrictions

NGT welcomes this consultation because it helps to clarify the form of price controls and incentives to be put in place under BETTA. These issues are key to completing the design of BETTA and establishing the commercial framework in which the Scottish TOs and NGC will interact.

Form of TO Revenue Restrictions

We agree with Ofgem's high-level objective that the incentive arrangements should encourage and reward efficient behaviour in the interactions between the transmission licensees in order to deliver GB transmission services efficiently to customers. We also agree that the ideal transmission owner incentive arrangements would result in the delivery of transmission services under BETTA in the same manner as would be delivered by an efficient integrated transmission company. However, while we believe the TO incentives proposed by Ofgem are a pragmatic approach to establishing initial TO incentives for BETTA go-live in April 2005, we believe that the incentives fall short of the ideal in the following ways:

1. The ownership of networks under BETTA will necessarily create a new interface between the Scottish TOs and the GBSO. This interface will inevitably introduce some inflexibility and transaction costs into the relationship between the GBSO and Scottish TOs that would not be present in an integrated SO/TO company. (Indeed, for this reason, we believe it would both be inefficient and unnecessarily increase costs to GB customers if we were to establish such an interface within NGC between our GBSO role and transmission owner role in England and Wales).

2. Ofgem's proposed combination of an RPI-X revenue restriction and a mechanism for recovering the cost of adjusting outages after the year-ahead plan has been agreed does not replicate for Scottish TOs the incentives that exist within NGC to make available transmission assets in such a way that minimises the costs to customers.

3. The continuing affiliation of transmission companies within Scotland with local generation interests will inevitably lead to certain conflicts of interest within the Scottish TOs corporate groups. This is because measures that a transmission owner might take to reduce balancing costs for end-customers are also likely to result in reduced payments to the affiliated generation business.

National Grid Company plc
Registered Office: 1-3 Strand, London WC2N 5EH
Registered in England and Wales, No 2366977

Transco plc
Registered Office: 1-3 Strand, London WC2N 5EH
Registered in England and Wales, No 2006000

National Grid Transco

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

4. Due to the lack of time available prior to the date when the BETTA arrangements go-live in April 2005 it will not be possible to have assessed and agreed a "year ahead" outage plan with the Scottish TOs. As a result of this, it is likely that a larger number of outage adjustments may be required after the year-ahead plan has been agreed than would normally be the case under a fully assessed and agreed "year ahead" plan. This will clearly result in increased costs being incurred by the GBSO.

Because of these specific problems, we expect the balancing cost targets and risk sharing arrangements proposed by Ofgem for any GBSO incentive scheme should reflect the particular circumstances arising out of the implementation of BETTA. We recognise that these might be different, at least initially, from those that might be adopted by Ofgem in ideal circumstances.

In order to provide strong incentives to manage balancing costs under BETTA but mitigate the effects of risks that may be beyond the control of the GBSO, we suggest that Ofgem should consider, amongst other measures, the use of asymmetric SO incentive scheme sharing factors. Such factors should be used until experience of how BETTA actually operates in practice is gained and would follow the approach adopted by Ofgem for the SO incentive scheme in the first year of NETA given the uncertainties that existed at that time..

Further detailed comments concerning the form of the SO incentive scheme are also set out below.

On the specific proposals (summarised in paragraph 9.1 of the consultation document) our views are as follows:

a) making adjustments for the TOs' revenues in respect of investment through the process of price control review, in a manner consistent with current practice

The consultation considers three approaches to establishing incentives on TOs with respect to network investment. Our comments on each of these are as follows:

<u>Approach 1: Make adjustments to TO revenues in respect of every metric which imposes or reduces additional costs on the TO or delivers additional benefit or imposes costs on the GBSO.</u>

This approach depends on the development of a potentially large and complex set of metrics. As the GBSO costs and benefits arising from the actions of a particular TO cannot be uniquely identified, such metrics will necessarily include a degree of approximation. For this reason, we consider that it is unlikely that a set of suitably accurate metrics can be derived. In any case, the development of such metrics in the time remaining before BETTA go-live is very unlikely to be practicable. As a result, we agree with Ofgem that this approach should not be adopted.

<u>Approach 2: TOs and GBSO to negotiate adjustments to the revenue restriction that was set at the price control review.</u>

This approach would place the GBSO in a pseudo-regulatory role and thereby jeopardise efficient interactions between NGC and the Scottish TOs. As such, again, we agree with Ofgem that this approach is not suitable for adoption.

<u>Approach 3: GEMA to make adjustments to the price controls on a case-by-case basis.</u>

This approach is consistent with the processes that Ofgem currently uses to reassess price control revenues following a request by a licensee in the event of it incurring investment costs not foreseen at the time of the previous price control review. Although it does not introduce new incentives to ensure efficient network investment, it would ensure that revenue restrictions set in a price control review do not become a significant barrier to undertaking efficient investments if new

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

circumstances arise. We note that the number of occasions on which such an approach by NGC or Scottish TOs may be necessary might be reduced by the inclusion of an appropriate revenue adjustment (such as a more efficient form of NGC's Gt term) in each revenue restriction. This issue is discussed further below.

On this basis, we agree with Ofgem that the 3rd option is the most appropriate.

If Ofgem makes such adjustments to TO revenues between price control reviews, the timing of the revenue adjustment relative to the timing of the annual setting of the GB TNUoS tariff would need to be considered. For example, if the GBSO was obliged to increase the revenue paid to the TO before a revised tariff could be implemented then we would need to finance the increase until new charges were implemented and we should be permitted to recover these financing costs.

b) adjustment to the TOs' revenues in respect of outage plan changes through a process of declaring costs to, and decision by, the GBSO

Ofgem proposes that Scottish TOs should receive additional revenues to cover the costs of adjusting network outages to meet requests by the GBSO after the year ahead plan has been agreed. A pure RPI-X revenue restriction on TOs would provide incentives to optimise maintenance costs and this would usually seek to minimise the rescheduling of outages unless there was a specific benefit to the TO. We therefore agree that the payment of any additional costs incurred by TOs when responding to requests by the GBSO to adjust outages would usefully modify the RPI-X incentive.

To avoid the GBSO needing to act in a pseudo-regulatory role and scrutinising the costs declared by the TOs, we would prefer all costs notified by the TOs for outage adjustment to be regulated by Ofgem. We therefore support Ofgem's suggestion that TOs should at least be subject to an obligation to make declarations that reflect reasonable and efficiently incurred costs.

In order that we, as GBSO, will have incentives to efficiently choose between modifying an outage at short-notice or incurring the external balancing costs that would arise if the outage were not modified, we believe that the cost incurred by TOs in modifying outages as a result of requests by the GBSO should be included in the SO incentive scheme as part of incentivised balancing costs. As such, they would become subject to the same sharing factors that are applied to the constraint costs that we would incur if the outage were not modified.

In paragraph 8.20 of the consultation, Ofgem states that, whereas many TO costs paid to TOs will be directly attributable to NGC's Transmission Network Revenue Restriction (and so recovered via TNUoS), short-term outage changes might be attributable in different ways "depending on why the outage costs were incurred". If the costs are incurred at the request of the GBSO and included with other incentivised balancing costs, we believe it is logical to recover these costs via BSUoS charges. Such a treatment would also considerably simplify network charging and associated IT system developments, assisting implementation by April 2005. On this basis, we would bring forward GB charging methodology proposals concerning the particular half-hours over which these costs would be recovered.

For outage changes requested by TOs after the year ahead plan has been agreed, we agree with Ofgem that a symmetrical system (whereby TOs would make payments to the GBSO so that the GBSO could pay for any consequential "knock on" changes to other outages) could result in unduly complicated arrangements. We believe that a suitable initial approach would be for the GBSO to identify any knock-on changes that would arise from the outage change requested by a TO such that, if the TO agrees to proceed with the change, the consequential changes are also agreed without additional payments by the GBSO to the TO.

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

As noted above, in the year prior to BETTA go-live, given the programme of other data exchanges and system developments required to implement BETTA, it is unlikely that it will be possible to fully assess and optimise the initial year-ahead outage programme in the manner which it is anticipated that it will be possible to do in future years. As a result, there could be a larger number of short-term outage changes than would be expected when the post-BETTA procedures are established. This will impose unavoidable additional cost on GBSO and should be allowed for any incentive arrangements.

We agree that a reasonable endeavours obligation on TOs to follow outage plans, particularly once outages have started, is a pragmatic approach and we take comfort that Ofgem will consider ex-post investigation and scrutiny. However, we consider that this approach could expose transmission customers and the GBSO to increasing costs and the risks of reduced supply reliability if TO service levels decline. We therefore request that Ofgem keeps such service standards under close review after the inception of BETTA.

c) relying on obligations rather than financial incentives in respect of transmission switching and providing transmission services

We agree that, for the initial implementation of BETTA, it is a pragmatic approach for transmission switching, initial outage planning, and the declaration of asset capabilities to be the subject of obligations on TOs, remunerated by an RPI-X price control, and subject to ex-post scrutiny by Ofgem. However, as with the issue of outage overruns, we consider that Ofgem will need to keep these areas under close review to ensure that these issues are operating satisfactorily after the implementation of BETTA.

Similarly, we suggest that the imposition of a specific obligation on the GBSO to avoid overstressing a TO's equipment would mean that it is not necessary for any further penalty or incentive to be included in the initial BETTA incentive arrangements. This is particularly the case because, if the GBSO were to overstress the TOs equipment, we would be liable for risks that could arise as a consequence in terms of safety, service reliability and potential balancing costs.

We note that, following approval of CAP048, which provides compensation payments to generators for disconnections, the GBSO under BETTA would be required to make compensation payments to generators in Scotland as a result of network faults. It is for consideration whether the GBSO should be able to pass on such costs to Scottish TOs. If such costs are treated in this way, then Scottish TOs would receive a financial incentive to maintain this aspect of their performance. If, however, the GBSO could not pass such costs to Scottish TOs, then we would expect Ofgem to make a suitable allowance for such payments in our price controls and we consider that Ofgem would need to keep this aspect of TO performance under close review (in the same manner as other aspects of TO performance mentioned above).

We are aware that the commercial boundary between generator equipment and transmission in Scotland may depart significantly from the commercial boundary that has been used in England and Wales. For example, certain assets in the radial generation circuits (up to and including generator transformers) could be classified as transmission network in Scotland, whereas they would be the responsibility of generators themselves in England & Wales. Such Scottish commercial boundaries would imply the transmission system would not meet the requirements of current security standards and therefore constraint and/or disconnection costs would be expected to arise which otherwise would not. If such commercial boundaries are accepted under BETTA, we would expect the relevant customers to enter agreements to ensure additional constraint and disconnection costs do not arise and also Ofgem to provide the required directions to the security standards.

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA
T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

d) reflecting typical industry-standard terms concerning liquidated damages for new connections as between users and the GBSO, and as between TOs and contractors, in the terms and conditions between the GBSO and TOs

NGC agrees that the approach of ensuring the liquidated damages payable by the GBSO to customers (as agreed in the GBSO connection terms) should be reflected in the terms between the GBSO and TOs. This approach should ensure that any losses lie where they fall and the appropriate party compensates the customer. However, for this to work, we would need to be sure that Ofgem would not interpret the cross-default obligation terms within the financial ring-fence provisions of NGC's licence so as to prevent such "back to back" arrangements.

Following the recently approved change in connection boundary, connection assets are likely to be only a small part of the total works required to accommodate a new customer. This may mean that the liquidated damages payable to the customer may be small compared to the guarantees that the customer might be required to provide for associated infrastructure works. It is for consideration, therefore, whether revised liquidated damages arrangements would be beneficial. We believe this issue should be examined and developments to the liquidated damages arrangements be considered following BETTA implementation.

We note that Ofgem has decided that connection charges should be treated as excluded service income (as is current practice). This implies that TOs will provide information to the GBSO so that future payments by the GBSO to the TOs will match the arrangements agreed between the GBSO and customer (for example, concerning capital contributions, indexation arrangements, etc). It is to be decided whether risks arising from customer defaults are also passed through to the TOs or remain with the GBSO (the owner of the agreement). We suggest this matter is decided in the relevant BETTA Development Group and a suitable allowance for credit policy costs is then made in either NGC or TO price controls as appropriate.

We also note that the adoption of NGC connection charging arrangements in Scotland will require a revised treatment of capital expenditure associated with generation connections in the price controls of Scottish TOs. We understand that the arrangements in Scotland required generation to pay full capital contributions on all works required to connect and accommodate the generation (a deep connection methodology). This implies that the associated assets are not included in the Scottish TO regulatory asset bases (RABs). Under the shallow charging methodology proposed for implementation under BETTA, both infrastructure and connection assets associated with new connections would need to be included in Scottish TO RABs and the forecast level of excluded service revenue taken into account in setting the RPI-X price control (including the effects of any replacement of connections assets). We assume that such forecasts will be agreed between the Scottish TOs and Ofgem and would not involve the GBSO directly. Similarly, we would expect any repayment of capital contributions for deep connections to transmission customers in Scotland to be resolved by the Scottish companies and Ofgem prior to BETTA go-live and the implementation of the GB shallow connection charging methodology.

e) the effect on NGC's Balancing Services Revenue Restriction sharing factors

In terms of mitigating the risks that will arise under a SO incentive scheme from the particular ownership arrangements under BETTA and the uncertainties concerning how GBSO/TO interactions will function, we welcome Ofgem's consideration of revised SO incentive sharing factors. We agree with Ofgem's view that it will not be possible to identify uniquely, or extract in a simple and precise manner, the constraint costs arising as a consequence of Scottish TO actions. Even if such costs could be identified using an acceptable methodology, the introduction of different SO incentive scheme sharing factors for costs incurred in Scotland compared to those arising elsewhere could establish perverse incentives to unduly favour or avoid taking balancing

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

actions within Scotland when an alternative elsewhere is available. Therefore, we strongly believe that all GB balancing costs should be part of the same “bundled” incentive scheme.

NGT believes that strong incentives in the SO incentive scheme have been important in encouraging innovation and efficiency improvements that have resulted in the significant benefits that have been delivered to end customers. To retain these incentives, but mitigate the new risks under BETTA that may lie beyond the control of the GBSO, we suggest that it would be beneficial to establish asymmetric sharing factors, at least initially. This would be similar to the form of the SO incentive scheme set for the first year of NETA when practical experience of the risks of potential additional costs had not been gained.

f) the effect on NGC’s GT term

The consultation document seeks views on the possible development of NGC’s revenue restrictions associated with the Gt term.

The Gt term in NGC’s TO price control adjusts NGC allowed revenue to reflect the additional (or reduced) financing costs associated with capital investment required to accommodate more (or less) generation within England & Wales or interconnector capacity than was assumed when the price control was set. The capital investment (rather than the financing costs allowed) is assumed to be £23m per GW of generation and is irrespective of the location of generation within England and Wales. This means the mechanism represents only a very approximate adjustment of revenues to reduce the effect of the uncertainty in the overall level of generation connections forecast at the last price control review. For this reason, we would expect the financing costs of capital investments identified at the price control review to be explicitly included in the TO price control rather than solely provided by Gt-like terms. In particular, we believe the financing costs of the investments that would be needed to support the additional transfers from Scotland resulting from new renewable generation should be addressed in the forthcoming “mini-review” and included in our price control.

Given the end of the Anglo-Scottish Interconnector agreements and the new access arrangements for generators (including those in Scotland) to the GB market, we believe it would be appropriate to adjust the workings of the Gt mechanism so that it refers to all contracted generation rather than just generation contracted in England & Wales.

Moreover, given that the recent study of potential transmission reinforcements required to accommodate new renewable generators in Scotland has highlighted the potential for investment costs to be considerably higher than £23m/GW for both NGC and Scottish TOs, we would support the development of locational Gt terms for all three transmission licensees. This approach offers the potential to address a major uncertainty and risk that would arise under NGC and Scottish TO price controls.

In paragraph 8.14 Ofgem correctly notes that the Gt terms would not affect the locational messages that customers would receive from transmission charges as these are determined by the charging methodology. We believe, however, that there would be merit in deriving locational Gt terms using a methodology which is consistent with that used in the derivation of TNUoS locational differentials. Such an approach would ensure that the additional allowed revenue for transmission companies would tend to equal the charges paid by the new customer in that charge zone, and consequently the level of charges to other customers would tend to remain unchanged.

NGT House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

T +44 (0)1926 653000
F +44 (0)1926 654378
www.ngtgroup.com

g) the mechanisms for effecting possible changes to the NGC's revenue restrictions as a result of changes to TO's revenue restrictions

Ofgem propose two approaches to adjusting our revenue in the event that they increase the revenue to Scottish TOs:

1. assume as a default that any additional revenue for Scottish TOs will be to the benefit of the GBSO and so total GB revenues should not be adjusted; or
2. assume as a default that the additional revenue for Scottish TOs should be passed through so that total GB revenues would increase.

In the specific case of additional revenues paid to Scottish TOs as a result of the GBSO choosing to adjust outages after the year ahead outage plan has been agreed, for the reasons described above, we believe that the costs should be included in the incentivised balancing costs "bundle" and subject to the same sharing factors as other balancing costs.

In the case of other adjustments to Scottish TO revenues, we assume these will be the result of adjustments made by Ofgem to reflect additional investment costs associated with developments not anticipated at the previous price control review. In this case it would be wrong to assume that such costs would be to the benefit of the GBSO. (If the additional costs were anticipated then presumably they will normally be allowed for the correct licensee. If they are not anticipated presumably they will not have been allowed for any party). Moreover, as changes warranting additional investment costs in Scottish TOs will almost certainly result in additional investment costs being required by NGC as well, we strongly believe the default position should be as set out in the second of the approaches summarised above i.e. that the additional revenue for Scottish TOs should not affect NGC's revenues. For the avoidance of doubt, the GBSO revenue restriction should also be defined such that it permits the pass through of all allowed revenues set in price controls for NGC and Scottish TOs.

If you wish to discuss any part of this response, you might contact myself or Lewis Dale (Tel 01926 655837).

Yours sincerely,

Tim Tutton