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Dear Cheryl

Initial consultation on transmission investment incentives

We recognise that the Government's commitment to meet its 2020 renewables targets is creating major challenges for the transmission system and its orderly expansion. We think it is necessary to review incentives for investment by transmission owners as part of the transmission access review and in advance of the negotiation of the next transmission price control.

The key issue for consumers in reviewing current policies is the need to strike an appropriate balance between enabling timely investment in the transmission system on the one hand and protecting consumers from unnecessary, premature or inefficient investment on the other. The scale of the transmission investment envisaged – which has been estimated at as much as £6bn *in addition to* the £4bn allowed under the current price control - is substantial and will increase costs to hard-pressed consumers through their electricity bills, and changes that could facilitate earlier and faster expenditure could increase these pressures. The timescales for delivery of the new investment are short if new targets are to be met. These pressures make it all the more important that consumers' interests are not subordinated or sacrificed in the interests of speed.

That said, we think the proposals set out in Ofgem's consultation document are along the right lines. Overall if the revised incentive package is structured appropriately transmission companies should be able to deliver their capital expenditure programmes more efficiently with customers benefiting over time. We have set out our detailed responses to the consultation questions below.

Yours sincerely



Robert Hammond
Head of Regulated Industries

Initial consultation on transmission investment incentives

Response to questions by Consumer Focus

CHAPTER: Two

Question 1: Do respondents agree that there is a need to put in place a framework for anticipatory investment in order to facilitate achievement of the 2020 targets? Do respondents agree that such arrangements should be developed for application to transmission projects commencing within the current transmission price control?

We agree that there is a need for an explicit and unambiguous framework for anticipatory investment. Indeed there is an argument that transmission owners cannot meet licence objectives without it. Under the current regime there is a real disincentive for the transmission companies to undertake such investment as they could carry the risk that some or all of their investment may be disallowed by the regulator in setting allowed revenues. This absence has been one factor contributing to the size of the GB queue.

We also agree that anticipatory investment arrangements should be developed for transmission projects commencing in the current price control as the distortion is impacting now, and it would not be appropriate to delay consideration of this issue until TPCR5. Given the 2020 targets and the fact that the current price control does not finish until 2012, delay would put greater stress on the need to build infrastructure faster with potentially greater risks that consumers may be asked to pay for unnecessary or premature investment.

We note that Ofgem proposes that any arrangements put in place for anticipatory investments that commence during TPCR4 would be unaffected by any proposed changes from the RPI-X@20 review, which reduces the regulatory risk of this proposition. Indeed we would respond that this highlights the need to draw review processes together and conclude them sooner rather than later.

Question 2: Do respondents agree that this work should first focus on identifying and addressing barriers to investing ahead of need, before putting in place appropriate incentives to undertake investment ahead of need?

This seems a sensible approach. We would add that there seems to exist a considerable volume of work from Transmission Access Review (TAR) and related review processes that have already documented the problems. Please also see our comments below on Chapter 4.

CHAPTER: Three

Question 1: Do respondents have any views on the proposals received from the transmission companies? Do respondents consider that we have appropriately considered the impediments to anticipatory investment identified by the transmission companies?

We concur with the assessment of the impediments to anticipatory investment, namely: uncertainty over funding for pre-construction works; revenue driver triggers requiring full user commitment; works being contingent on other reinforcements; and UCAs don't reflect sizing options.

Please see also our response to Question 2 on chapter 3 below on the transmission companies' proposals.

Question 2: Do respondents consider that it is appropriate to take the current arrangements as a starting point for developing a framework for anticipatory investment? Have we identified the relevant issues to consider in taking this work forward, e.g. in relation to the definition of anticipatory investment and the design of an incentive mechanism? Do respondents have any views on the appropriate balance of risk and reward in relation to investment undertaken on an anticipatory basis?

In general we consider that adapting the current framework is the only practical way forward and probably the only method consistent with the open access model adopted in Britain and rolled out to Scotland in 2005. It would also, in our view deliver, a lower risk approach to alternatives.

The discussion in the document makes clear that there are a range of potential options for a framework for anticipatory investment. We support the regulator's intention to ensure that, in designing an incentive mechanism, it will seek to ensure that there is consistency with the risks and returns available in other contexts, such as the regulated returns under the price control or Transmission Investment for Renewable Generation (TIRG), or the returns expected for investments in comparable circumstances.

Views are invited on whether Ofgem should pursue a competitive approach to the investment required for 2020. We think that the regulator should consider the potential benefits of some significant new projects being opened up to competition. The scope for such application could be greater where identifiable beneficiaries are involved; conversely the scope could be more limited for infrastructure assets that are meshed with the existing system.

We note that Ofgem considers that there could be "significant reductions" in the costs to consumers in the event that this investment is secured at a lower rate of return. The approach

adopted would need to be proportionate to the costs and risks involved, however, given the potential benefits, it should be fully explored. Ofgem has of course already established such a framework for offshore transmission assets, and there is already some contestability in new connection provision.

We agree that the relevant issues have been identified (length of incentive period; level of incentivized costs; triggers; proportion of pass-through) to take this work forward. In respect of the appropriate risk/reward balance, we agree that any mechanism and associated returns should be commensurate with the level of risk to which the transmission owners are exposed and the degree of control they can exercise over the risk. We note that both Scottish Power Transmission and National Grid's proposals would see them earning a higher return on efficient, timely (or early) investments than under that the standard price control, and higher than those allowed for in TIRG of 8.8%. Given that Ofgem stated in the TIRG final proposals that there is no compelling evidence that transmission reinforcement for renewable generation is at higher risk of stranding than other transmission investment, on the face of it these proposals seem to be pitched too high.

The option set out for a potential incentive mechanism to reflect asset utilisation appears an appropriate approach. But setting an appropriate balance of risk between the transmission owners and customers is clearly a crucial issue here. The transmission companies have a substantial amount of information derived from the GB queue as it has built up, and arguably this must limit the amount of uncertainty as to where and how much investment is required.

Question 3: Do respondents have any views on our proposed way forward, including our proposal to separate short term work to measures address current and immediate barriers, from further measures, developed over a longer timescale, to allow funding for investments that could be commenced under the current transmission price control? Do respondents have any views on how we propose to address interactions with the RPI-X@20 project?

We consider that the proposal to separate short-term work on proposals to address current and immediate barriers from other measures developed over a longer timescale is appropriate.

We also consider that the approach in respect of the RPI-X@20 project is appropriate and necessary to minimize the regulatory risk of the overall developments. In reality arrangements revised now will need to endure through TPCR5 as a minimum.

CHAPTER: Four

Question 1: Noting the large allowances that have already been made, what measures could be taken to enhance the regulatory treatment of pre-construction costs, whilst protecting consumers from expenditure that turns out not to be efficiently incurred?

Of the two potential approaches proposed, we think it would be preferable to retain the element of incentive, and therefore we consider that the mixture of pass-through and incentivisation approach is more appropriate than a “logging-up” treatment, which could result in steeper price changes than consumers were expecting. We agree with Ofgem’s observation that there are also concerns with the logging option owing to the weaker efficiency incentive and the lack of funding certainty.

Question 2: Do you agree with our view that there is a less compelling case to revise the existing local works revenue driver provisions, and that short-term improvements could be better focused on the funding arrangements for deep infrastructure works?

We agree with this assessment - in the case of local works, we consider that requiring user commitment is fitting and represents an appropriate balance between consumer interest and renewables growth.

Question 3: What are your views on the enhancements that could be made to the funding arrangements for deep infrastructure works, and do you consider that we should focus our attention on delivering quick wins in the short term?

Ofgem suggests that one option in the short term would be to provide regulatory funding for a number of specific projects that need to proceed imminently without explicit dependency on formulaic revenue drivers or MW trigger thresholds. We strongly agree with its statement that if this approach were taken there would need to be appropriate safeguards to protect consumers and avoid inefficient investment. Given the immediacy of the need to begin investment, the strong safeguards in this area are very important and need to be defined urgently.

CHAPTER: Five

Question 1: Do respondents have any comments on our proposed approach?

We consider that the proposed three-part approach represents an appropriate way forward. We see no reason why the first package of changes comprising short-term measures cannot be implemented during spring 2009. As for the further measures, given their importance, we would hope this would be subject to some form of workshop before the details are locked in.

Looking forward these are the sorts of issue – capex, risk allocation – that might be better accommodated within a constructive engagement framework with direct consumer representative involvement, assuming this were appropriately funded.

Question 2: Do respondents have any views on our proposed consultation process for taking forward the development of our proposed short-term measures and further measures?

We note there appears to be no point at which any interactions between the CUSC CAP161-166 proposals have been or will be considered in the process. It is by no means clear that interactions would be the same if any combination of CAPs 161-164 were implemented on the one hand and either CAP165 or 166 on the other.