

consultation2012E15@acer.europa.eu

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14 November 2012

Dear Sir/Madam

Review of the ITC annual cross-border infrastructure compensation sum

National Grid is an international electricity and gas company and one of the largest investor-owned energy transmission and distribution companies in the world. We play a vital role in transporting energy to millions of customers across Great Britain and the Northeast US in an efficient, reliable and safe manner.

We thank ACER for the opportunity to respond to the above consultation. Our response is made on behalf of National Grid Electricity Transmission plc ("NGET") which is the National Grid subsidiary holding an electricity transmission licence for GB. NGET is also the National Electricity Transmission System Operator for GB and has been certified as ownership unbundled under the Third Package and designated as a TSO in GB.

The main body of the response contains our general thoughts on both the ITC Infrastructure Fund ("the Fund") and the report produced by Consentec. Answers to the specific questions posed in the consultation can be found in ANNEX 1.

As stated in previous responses, NGET is supportive of the general principles behind the implementation of the ITC Mechanism, namely facilitating effective competition and ensuring cost reflectivity and non-discrimination, as these will provide for the sustainable and efficient development of the European grid network for the betterment of all European citizens. We share the view reached by the Florence Forum (1999) that the negotiated cross-border transmission fees that were used to compensate transited countries before the introduction of the CBT agreement in 2002 hindered the development of the Internal Energy Market.

We welcome the work carried out by Consentec to develop a methodology by which to construct an appropriate fund size. It is clear that the ITC Mechanism is a subject which significantly divides opinion across European stakeholders and therefore we believe it was of vital importance to attempt to seek an independent view of how it can be improved.

However, we feel that there are a number of other options that could have been considered in the report which would also have contributed to the discussion at hand. For example, in this type of study

we believe it is normal for the benefits and drawbacks of a “Business as Usual” option to be analysed. Also, there are a number of ITC stakeholders who believe that the best option would be to set the size of the Fund to zero (and resolve any residual issues locally) and it would have been useful had the implications of this option been explored in more detail in the report.

Whilst we fully appreciate that the scope of this current review is strictly limited to an assessment of only the size of the Fund we nevertheless believe that, given the diverging views of ITC stakeholders in relation to how contributions to and compensations from the fund are allocated (not to mention the development of several other important areas at a European level such as development of the Target Model for electricity, the treatment of loop flows and arrangements for merchant investment in cross-border assets), the size of the Fund can not be increased without a fully holistic review of the ITC Mechanism. This is to ensure that it doesn't result in any misaligned signals or incentives, particularly in terms of future investment.

There may also be an argument to suggest that, due to the upcoming introduction of a number of new European Network Codes, it may be beneficial to first see the effects of these codes before making major changes to the ITC Mechanism. In addition, several initiatives which may interact with the ITC Mechanism (such as the Energy Infrastructure Package (“EIP”)) are not yet ready to be implemented so there may be value in waiting until the implications of these are better known and can be better catered for.

Therefore, in the absence of the holistic review mentioned above, our position is that the size of the Fund should remain at its current level of €100m. We are conscious that reaching agreement at this level was the result of considerable compromise and negotiation over a number of years which, given that very little has taken place since the introduction of Regulation (EU) No 838/2010 (“Regulation 838”) to suggest a wholesale change, should not be readily dismissed.

Finally, another reason why we favour retaining the existing fund size, at least until the method by which contributions to and compensations from it are determined is also reviewed, is that we think this approach is consistent with the conclusion reached by Consentec in the report¹ that it is doubtful whether an “abrupt change would be consistent with the fact that the current fund size in combination with the method for determining relative payments constitutes a consistent implementation of the requirements of Regulation 714”.

We are more than happy to answer any questions you may have on this response. Please contact Alex Haffner on +44 (0) 1926 65 5838 or at alex.haffner@nationalgrid.com in the first instance.

Yours faithfully,

Patrick Hynes

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National Grid

¹ 2nd paragraph of page 42.

ANNEX 1

Please see below answers to the questions contained in the consultation document. Note that these answers should be considered bearing in mind our firm belief that a wide-ranging review of the whole ITC Mechanism is necessary before the size of the Fund can be increased from its current level of €100m.

1) Has Consentec's study considered a sufficient range of potentially suitable options for assessing the ITC infrastructure fund? What other options do you believe should be included in the assessment?

We believe that there would have been value in considering the option of reducing the size of the ITC infrastructure fund to zero and attempting to pinpoint issues on a more local basis (e.g. such as looking into arrangements whereby TSOs which contribute to flows in transited countries are obliged to contribute to the cost of providing additional transmission capacity). This is because of how difficult it has been, and continues to be, to find a mutually agreeable Union-wide solution. Another option which could have been considered might be, if it is assumed that the costs of new transmission assets supporting cross-border flows will likely be met by revenues received as a result of auctioning cross-border capacity or through the EIP, to decrease the Fund annually from its current level (so that it is at zero by a certain date) to reflect the depreciation of existing assets.

2) Are the criteria adopted to assess these options and their application to the identified options appropriate? What additional or alternative criteria do you think should be applied?

The criteria adopted by Consentec in assessing the options, namely compliance with legal provisions and compliance with congestion management and the EIP, are clearly highly relevant. In terms of compliance with legal provisions, it would appear that whilst the "incremental approach" is consistent with the mandated use of LRAIC as set out in both Regulation (EC) No 714/2009 ("Regulation 714") and Regulation 838, the "absolute approach" and the "restricted absolute approach" lend themselves more to use of a regulated cost base to reflect historic costs. As Regulation 714 specifies that compensation payments shall reflect "cost actually incurred", the use of any kind of Modern Equivalent Asset Value ("MEAV") would appear to conflict with this requirement.

We agree with the assessment made in the report that it is appropriate that the EIP should not be considered within the scope of the study until such time as it comes into force. However, note our suggestion in the main body of the letter that it may be beneficial to wait until more clarity is available on the EIP before making significant changes to the ITC Mechanism.

More detail on the treatment of congestion revenues is given in answer to question 5 below.

3) Of the options identified by Consentec, do you have any preferences? If so, please provide reasons for your preferences.

For the reasons outlined above (i.e. compliance with legal provisions), if we had to consider only the options identified by Consentec, our preference would probably be for the "incremental approach" to be used to set the size of the Fund. However, there are also a number of other reasons why we think that this is the most appropriate of the options considered.

Firstly, the setting of the current fund size to €100m was the result of prolonged negotiation and compromise between the TSOs involved. We find it hard to see what has changed since its introduction to render this compromise not fit for purpose.

Furthermore, as referred to in the report, by endorsing the current fund size (by its inclusion in Condition 5.4 of the Guidelines attached as Annex Part A to Regulation 838) the legislator has deemed it to be a consistent interpretation of the requirement of Regulation 714. This would implicitly suggest that anything which deviates significantly from the current fund size (e.g. the “absolute approach”) is therefore not a consistent interpretation of the Regulation.

We note the intention behind the idea of a “restricted absolute approach” but it seems that the choice of reference year is almost entirely arbitrary and that the approach is therefore more a means of reducing the fund size to within the “usually discussed bandwidth of ITC infrastructure fund sizes” than a theoretically robust methodology in its own right.

Whilst we can appreciate that there may be some advantages in using the “absolute approach” to determine the size of the fund, we believe that there are still too many areas where methodological shortcomings (both in the “absolute approach” itself and, more importantly, in the allocation of ITC infrastructure contributions and compensations) that we cannot support it at this stage. Some of the areas that we are concerned about are outlined in our answer to questions 4 and 5 below.

4) Are the assumptions adopted for the illustrative numerical analysis appropriate? Considering the practical limitations of availability, what other data or assumption do you believe should be used in such analysis?

We recognise the issues related to availability of data experienced by Consentec and, for the most part, believe that the assumptions employed to get around this are appropriate. We are aware of some issues around the application of the GTS to different voltage layers and to the treatment of connection assets that requires further attention. Also, there is a question around the treatment of depreciation of new assets in the options proposed by Consentec which appears to require clarification.

More generally, we appreciate the need to balance the level of cost reflectivity with the need to produce results that demonstrate the effects and trends of different methodologies. Therefore, so long as the same assumptions are not employed to arrive at the determination of a binding fund size we are fairly comfortable with these assumptions. However, again, given our views on how the Fund is allocated in terms of contributions and compensations (i.e. that this needs to be reviewed before any increase can be made to the size of the Fund), this is largely academic.

5) How do you believe the different parts of the congestion revenues should be treated in calculating the ITC infrastructure fund and why?

In order to safeguard its principles, it is imperative that the ITC mechanism doesn't lead to any kind of double compensation and that only infrastructure funded by network tariffs is ultimately considered. This is because the whole purpose of the ITC scheme is to ensure that network users in one country are not cross-subsidising the cost of transporting flows for which the benefits accrue to network users

in another country. This implies not only that the “Wide Interpretation” (where, by not taking account of revenues used for purpose (a) of Article 16(6) of Regulation 714, only the profits generated by these cross-border assets are considered) should be employed but that, if it is assumed that all cross-border assets (including merchant interconnectors for example) are included in the total cost of transmission infrastructure applied in the formula for calculating the Fund size under the “absolute approach”, the option of netting off the entire amount of congestion rents should be considered.

It is important that, when completing this exercise, the GTS factor is applied to the total infrastructure cost before the total cross-border revenues are netted off. This is because congestion rent is only explicitly collected for cross-border exchanges and therefore the object of the exercise is to first pinpoint the assets that are used for international transit (i.e. not just the actual cross-border circuits) and then net off any revenues not collected through annual network tariffs (i.e. congestion rents).

We see this approach as being compliant with Regulation 838 as it constitutes an appropriate adjustment of the assessment of the costs incurred in making infrastructure available for cross-border flows. We further believe that this would be simpler than attempting instead to limit the total infrastructure cost to assets solely funded by annual network tariffs and that it therefore removes some of the practical difficulties of applying the “Wide Interpretation” outlined in the report (e.g. dependence on country-specific accounting rules). In addition, it would also mean that the issue highlighted in the Consentec report² where “By including the congestion revenues into the determination of the ITC infrastructure fund, one would effectively define the method for determining the relative compensations and contributions as European sharing key for at least a part of the congestion revenues” should not apply.

We do note that there may be cases where the costs of providing the infrastructure do not equate to the revenues received from the cross-border capacity auctions. However we believe that this should allow the ITC mechanism to act as an additional incentive to ensure that there is sufficient cross-border demand to justify investments. As European markets converge (as envisaged under the Target Model), although falling congestion rents will mean that the consumers in transited countries are required to contribute more to the costs of hosting cross-border flows, this reduction in congestion rents means that the ITC fund will increase to reflect this.

We also appreciate the point made in the report that, as the total EU annual congestion revenues are a factor of 10 higher than the current €100m fund, using the “Wide Interpretation” would raise issues under the “incremental approach” which uses this €100m fund as a basis and starting point. Therefore our view would be that, in the event that the “incremental approach” was employed, it should be ensured that, as far as possible, only new assets funded completely by network tariffs are added incrementally to the fund.

6) Do you agree with Consentec’s assessment and the preliminary conclusions on the options for determining the ITC infrastructure fund?

We agree broadly with the preliminary conclusions set out in the report that adopting the “absolute approach” would lead to too abrupt a change in the fund size (with the corresponding issues around the “consistent interpretation of the requirements of Regulation 714” point). On this subject, if the

² Paragraph beginning “It is important to recall...” on page 9.

“restricted absolute approach” was to be adopted with a reference date of 1996 a similar issue would apply. Therefore, of the options set out in the report, the “incremental approach” would appear to be the most appropriate in this respect.

7) What are your views regarding the suitability of using LRAIC to determine the ITC infrastructure fund? Do you consider the LRAIC proposed by Consentec appropriate?

We agree broadly with the view put forward in the report that it would have to be shown that LRAIC is clearly inferior to any other cost base in order to justify an amendment to Regulation 714 (where it specifically requires in Article 13(6) that LRAIC is used).

However, whilst we can support some of the high level principle of LRAIC, as mentioned previously this can only be introduced following a review of the methodology for allocating contributions and compensations to the Fund as well as the interaction between the ITC Mechanism and other market signals (e.g. IEP, the Target Model and merchant investment in cross-border infrastructure).

One issue that we are aware has been raised is to do with coherence of the rate of return employed under LRAIC with the sum of the costs of capital used in European network regulation. We would welcome further clarification on this area.

8) Are there any other issues that you believe should be taken into account in this review? In particular, how do you believe the on-going wider developments in the European energy market and regulatory arrangements should impact the Agency’s proposal on the infrastructure fund?

The review doesn’t seem to have considered in any detail the effects of the proposed options for the Fund on levels of investment in new cross-border investments. In particular, there is a prevailing view that setting the level of the Fund too high may actually hamper efficient cross-border investment by TSOs. This is because, as a result of imperfect allocation of the Fund, there may be a disincentive to invest for countries that are a net contributor to the Fund and an over-incentive to invest for countries that are net beneficiaries. This goes to the heart of the issue related to the ITC Mechanism in general which is whether investment in cross-border capacity by exporting and importing countries means that transited countries require more or less investment as a result. Put another way, are national transits offset at all by international flows or do all international flows mean that additional transmission capacity is required to support them. We would be very keen to see any further useful analysis on this as, although perhaps outside the precise scope of the review, it is still of vital importance when considering the fund size. One area that could shed some light on this is how losses in transited counties are affected by international flows.

Another issue that is not touched upon is the level of “future-proofing” that is required in the event that changes are made to bidding zones such that cross-border flows are redefined in a manner separate from national borders.