

March 2012 Business plan Arrangements for Incremental Capacity

1 May 2012
Transmission Workgroup



March 2012 Business Plan

- Following on from meetings with Ofgem and Industry, we outlined our thoughts and the associated views from stakeholders within the March 2012 submission
- Key documents within the business plan to reference:
 - Appendix B (Delivering connections and capacity) to Detailed Plan Annex
 - Provides details of our view of the changes to the regulatory and commercial regime; and
 - Managing Risk and Uncertainty Annex
 - Provides details of the relevant incentive arrangements.

Key drivers for proposed changes

- Two main drivers for regulatory change are:
 - Planning Act implications;
 - Scale of investment we could face and the implications of this on the financeability of the Transmission business.
- Three main drivers for commercial change are:
 - Customers have requested that connections and capacity processes are better aligned;
 - Planning Act implications; and
 - Maintain alignment between regulatory and commercial frameworks.

Key points to note

- Existing capacity release processes and associated funding arrangements will continue until 1 April 2013 (assume new arrangements will apply thereafter, but depends on progress with development of commercial changes).
- We recognise that changes will be needed to both the regulatory and the commercial regimes:
 - Two are inextricably linked together;
 - Industry process to be followed, recognising we are not in control of resultant (if any) commercial changes:
 - if these differ from our assumptions, then we'll need to revisit the regulatory framework.
- Also recognise that further changes may be needed as a result of European developments, but not covered here.

Key principles for capacity release

- At the time of TPCR4 we discussed a set of principles in relation to entry capacity substitution, the sentiments of which are equally appropriate when considering capacity release in general.
- Ensure that capacity release:
 - Is consistent with general obligations under the Act (and licence), specifically the duty to develop and maintain an efficient and economical pipeline system;
 - Taking account of the above, is provided by consideration of minimising costs;
 - Is compatible with the physical system, or
 - For incremental capacity, would be only where it is possible to respond to a signal (after taking account of the other principles identified here);
 - Should ensure efficient balance between investment and constraint costs; and
 - Should facilitate effective competition.

Proposed Regulatory changes

- Existing revenue drivers are removed from the licence:
 - New funding arrangements will be set on an “as and when required” basis
 - calculated using agreed Methodology & Unit Cost Library;
- Obligated lead-times to release incremental capacity (for both entry and exit) are reduced to Y+2 (24 months from October capacity allocation):
 - This will allow default of 2 build seasons to deliver capacity from formal signal;
 - With appropriate incentive around earlier/later release, which will provide flexibility to meet user requests.
- Introduction of a reasonable endeavours obligation to drive efficiency in the pre-planning stages.

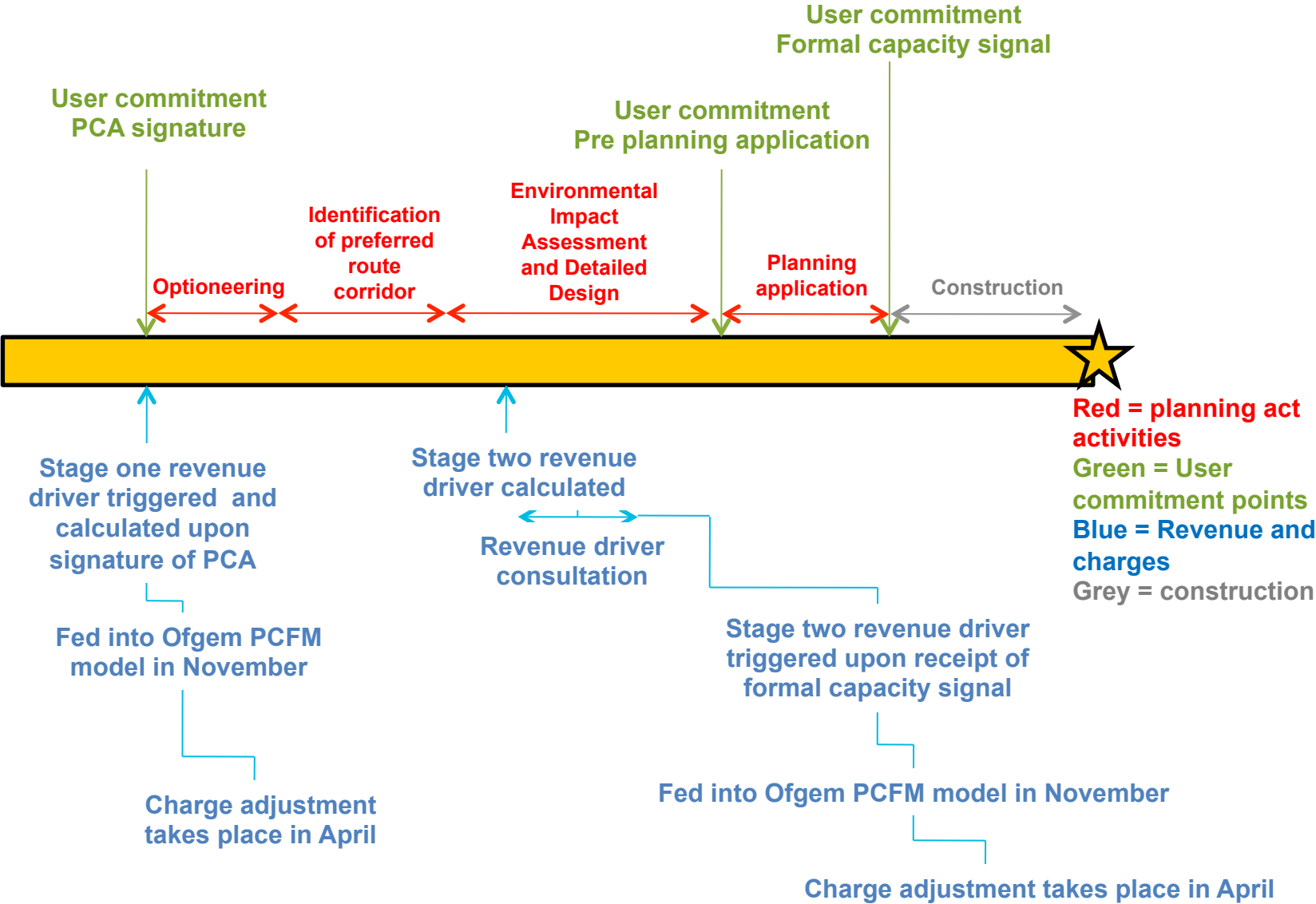
Proposed Commercial changes

- Entry and Exit application processes for baseline (including substitution and non-obligated) will remain unchanged
- Entry and Exit incremental application process will be based on the existing ad-hoc QSEC and ad-hoc exit enduring processes
- All customers requiring incremental capacity will need to enter into a bilateral contract to underpin the specific project timelines and the user commitment points;
- Aligns with the Mod 0373 connections process such that the same trigger is used where possible.

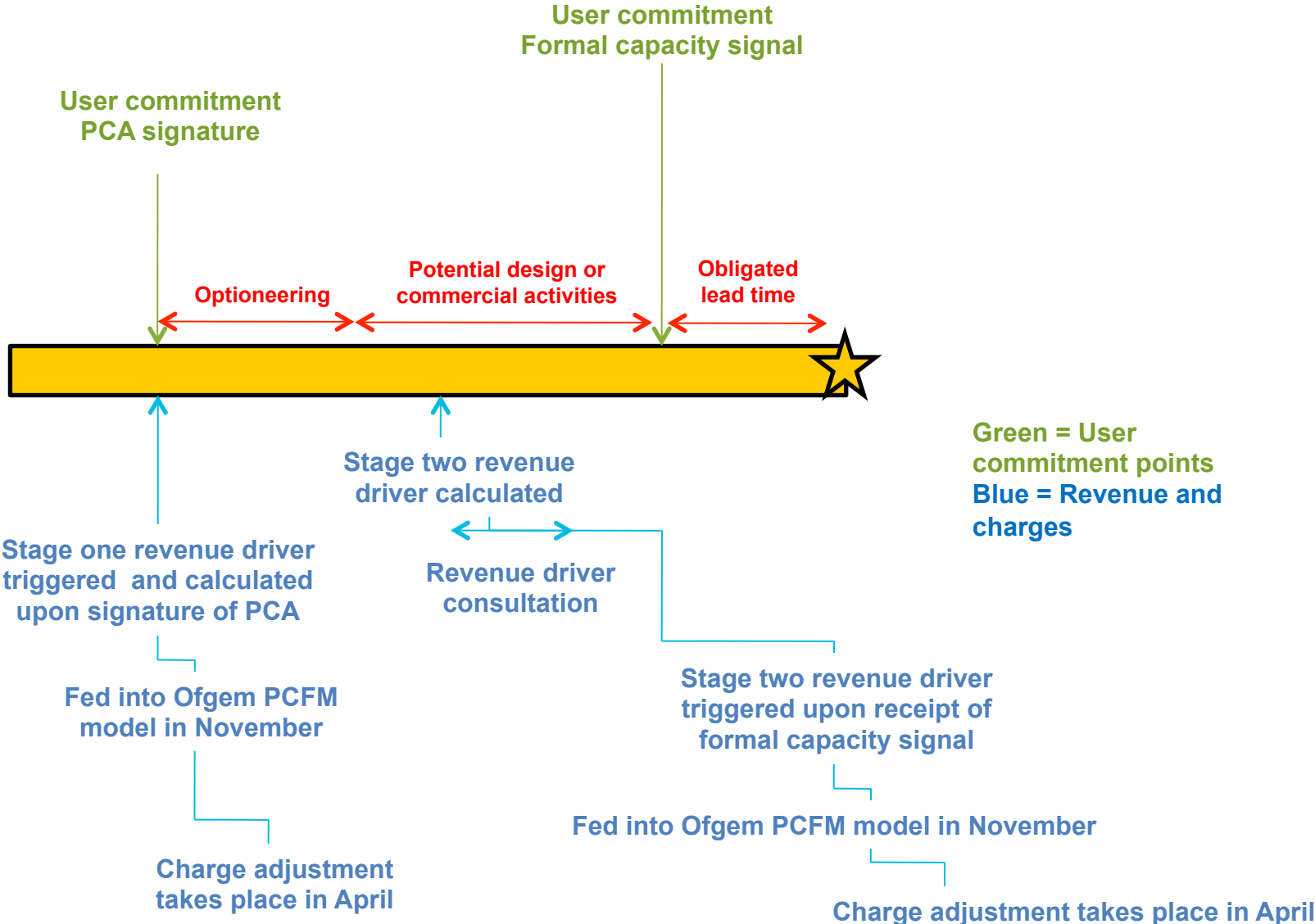
Process to release incremental capacity

- User approaches NGG for connection/incremental capacity (via bilateral agreement (PCA)). This will be a multi-phase approach, ultimately specifying:
 - How and when capacity will be provided;
 - User commitment points including phased profile;
 - Break out clauses;
 - Demonstration dates;
 - Dates for formal signal;
 - Trigger points for key activities (such as setting revenue driver or planning submission)
- In terms of triggers to release funding:
 - PCA provides trigger for pre-planning activity - “Stage one revenue driver”
 - Formal capacity application for post-planning activity funding - “Stage two revenue driver”

Proposed processes – where major planning consent required



Proposed processes – where major planning consent not required



Stage one revenue driver

- Used to allow funding of activities until formal capacity signal is received;
- Our proposal is for this revenue allowance to be triggered and calculated automatically on receipt of signed PCA:
 - Will be calculated from NTS Charging Transportation Model using user specified incremental capacity to derive a £m amount;
 - Phasing of funding over relevant years uses same assumption as that used in business plan for pipelines:

Years funded by stage one revenue driver				Years funded by stage two revenue driver		
T-5	T-4	T-3	T-2	T-1	T	T+1
2%	5%	5%	5%	35%	46%	2%

Stage two revenue driver

- Used to fund activities from formal capacity signal to delivery;
- Our proposal is stage two revenue driver is calculated following agreed methodology:
 - Triggered as per timeline within the PCA
 - Based on specific customer requirement and an agreed methodology statement and unit cost library;
 - A consultation would be held over the appropriate revenue driver;
 - Based on same phasing profile as was used for the Stage one process using refined cost estimate (for last three years) :

Years funded by stage one revenue driver				Years funded by stage two revenue driver		
T-5	T-4	T-3	T-2	T-1	T	T+1
2%	5%	5%	5%	35%	46%	2%

Stage one revenue driver - Worked example (1)

The location and size of a new customer project is entered into the Transportation Model, which calculates a total project cost of £100m. This is phased as below:

T-5	T-4	T-3	T-2	T-1	T	T+1
£2m	£5m	£5m	£5m	£35m	£46m	£2m
£17m				£83m		

Years T-5 to T-2 would be used to calculate the allowed revenue amount that will be triggered by the stage one revenue driver and the consequent adjustment to our allowed revenue.

If capacity were requested for use from October 2023, then T-5 would be 2018, hence the amount to be recovered would be as follows:

2018/19	2019/20	2020/21	2021/22
£2m	£5m	£5m	£5m

Stage one revenue driver – Worked example (2)

- Assumption is that the funding will be provided via totex framework using incremental capacity capitalisation rate of 90%
 - This would be provided via the TO price control not SO
- Proposal is to utilise the November annual update to the Price Control Financial Model (PCFM):
 - To determine the appropriate adjustment to the allowed revenue for the forthcoming formula year; and
 - To provide an indication of changes over subsequent formula years.

Stage one revenue driver - Worked example (3)

The incremental capitalisation rate (of 90%) would be applied which would result in the following allowed revenue recovery profile:

2018/19	2019/20	2020/21	2021/22		Total
£0.20m	£0.50m	£0.50m	£0.50m	'Fast' money in year of spend	£1.70m
£1.80m					
	£4.50m			'Slow' money depreciated in the RAV over 45 years	£15.30m
		£4.50m			
			£4.50m		
					£17.00m

Stage one revenue driver - Worked example (4)

This would result in the following allowed revenue stream:

	T-5 18/19	T-4 19/20	T-3 20/21	T-2 21/11	T-1 22/23	T 23/24	T+1 24/25	T+2 25/26	T+3 26/27	T+4 27/28	T+5 28/29	T+6 29/30
Assumed cost profile	2.00	5.00	5.00	5.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fast money	0.20	0.50	0.50	0.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Slow money	1.80	4.50	4.50	4.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Depreciation	0.00	0.04	0.14	0.24	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34
Return	0.06	0.25	0.52	0.78	0.90	0.88	0.86	0.84	0.82	0.80	0.78	0.76
Allowed revenue *	0.26	0.79	1.16	1.52	1.24	1.22	1.20	1.18	1.16	1.14	1.12	1.10

* Allowed revenue = Fast money + Depreciation + Return

Stage two revenue driver - Worked example (1)

When looking at the stage two revenue driver in isolation, this equates to phasing of:

Years funded by stage one revenue driver				Years funded by stage two revenue driver		
T-5	T-4	T-3	T-2	T-1	T	T+1
2%	5%	5%	5%	35%	46%	2%
17%				83%		
				35/83	46/83	2/83
				42%	55%	3%

If the stage two revenue driver, calculated in accordance with the agreed methodology, calculates a total allowed revenue adjustment of £150m (for the remaining work to be completed), the amount to be recovered would be as follows:

2022/23	2023/24	2024/25
63.00	82.50	4.50

Stage two revenue driver – Worked example (2)

- Again assumption is that the funding will be provided via totex framework using incremental capacity capitalisation rate of 90%
 - This would be provided via the TO price control not SO
- By utilising the November annual update to PCFM:
 - To determine the appropriate adjustment to the allowed revenue for the forthcoming formula year; and
 - To provide an indication of changes over subsequent formula years.
- We require funding to be available in time for capital intensive construction activities. November PCFM update enables:
 - 150 days notice of charge changes from 1st April of following year
 - 3 - 4 month workforce mobilisation

Stage two revenue driver - Worked example (3)

The incremental capitalisation rate (of 90%) would be applied which would result in the following revenue recovery profile

2022/23	2023/24	2024/25		Total
£6.30m	£8.25m	£0.45m	'Fast' money in year of spend	£15.00m
£56.70m			'Slow' money depreciated in the RAV over 45 years	£135.00m
	£74.25m			
		£4.05m		
				£150.00m

Stage two revenue driver - Worked example (4)

This would result in the following allowed revenue stream:

	T-5 18/19	T-4 19/20	T-3 20/21	T-2 21/11	T-1 22/23	T 23/24	T+1 24/25	T+2 25/26	T+3 26/27	T+4 27/28	T+5 28/29	T+6 29/30
Assumed cost profile	0.00	0.00	0.00	0.00	63.00	82.50	4.50	0.00	0.00	0.00	0.00	0.00
Fast money	0.00	0.00	0.00	0.00	6.30	8.25	0.45	0.00	0.00	0.00	0.00	0.00
Slow money	0.00	0.00	0.00	0.00	56.70	74.25	4.05	0.00	0.00	0.00	0.00	0.00
Depreciation	0.00	0.00	0.00	0.00	0.00	1.26	2.91	3.00	3.00	3.00	3.00	3.00
Return	0.00	0.00	0.00	0.00	1.74	5.73	8.00	7.94	7.76	7.58	7.39	7.21
Allowed revenue	0.00	0.00	0.00	0.00	8.04	15.24	11.36	10.94	10.76	10.58	10.39	10.21

And in total the allowed revenue would be:

	T-5 18/19	T-4 19/20	T-3 20/21	T-2 21/11	T-1 22/23	T 23/24	T+1 24/25	T+2 25/26	T+3 26/27	T+4 27/28	T+5 28/29	T+6 29/30
Assumed cost profile	2.00	5.00	5.00	5.00	63.00	82.50	4.50	0.00	0.00	0.00	0.00	0.00
Fast money	0.20	0.50	0.50	0.50	6.30	8.25	0.45	0.00	0.00	0.00	0.00	0.00
Slow money	1.80	4.50	4.50	4.50	56.70	74.25	4.05	0.00	0.00	0.00	0.00	0.00
Depreciation	0.00	0.04	0.14	0.24	0.34	1.60	3.25	3.34	3.34	3.34	3.34	3.34
Return	0.06	0.25	0.52	0.78	2.65	6.61	8.86	8.79	8.58	8.38	8.17	7.97
Allowed revenue	0.26	0.79	1.16	1.52	9.29	16.46	12.56	12.13	11.92	11.72	11.51	11.31

Summary of revenue driver funding treatment

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- Changes to the funding allowance would be via application of November update to the PCFM to affect allowances from the following April onwards;
 - This would provide an adjustment to the allowance based on incremental capitalisation rate (90%)
 - such that 10% provides 'Fast' money in year of spend;
 - 90% as 'Slow' money and funding provided for via depreciation and return on RAV;
 - Actual spend would be compared with allowance (based on the same capitalisation rate) to determine over/under-performance against allowance;
 - Differences would be dealt with via Totex Incentive Mechanism (TIM) efficiency rate (of 40%-50%), with 2-year lag.

Charging implications

- The price control settlement and hence the licence will provide for how the allowed revenue is calculated
- How that is then charged to customers is a charging debate which needs to be taken forward as part of the NTS CMF debate
- In our RIIO-T1 submission, we proposed the funding which needs to be provided is shared between the specific user and general charges on a 50:50 basis
 - Alternative options would include the user securitising 50% (to be drawn down in the event of the user withdrawing) with the total cost socialised
- As an industry, we need to establish a balance between creating barriers to entry and excessive socialisation of risk