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Open Letter to Industry – Offer Pricing Options

The GB System Operator is interested in industry views regarding pricing options in the provision of connection offers to the transmission system. The purpose of this open letter is to request feedback on existing pricing options, set out an additional option, and welcome proposals for alternative pricing options. The intention is to use the feedback received to review pricing options provided by the GBSO.

The specific questions to which the GBSO is seeking feedback are as follows:

1. As an applicant to National Grid, do you or your organisation have a preference for any of the three pricing options as set out in the discussion below?
2. What is the reason for your preference? i.e. what impact would each approach have in your financing options (if any)?
3. Can you suggest other pricing options that may be preferable?
4. Which combination of price type options should be made available to Users?

Background

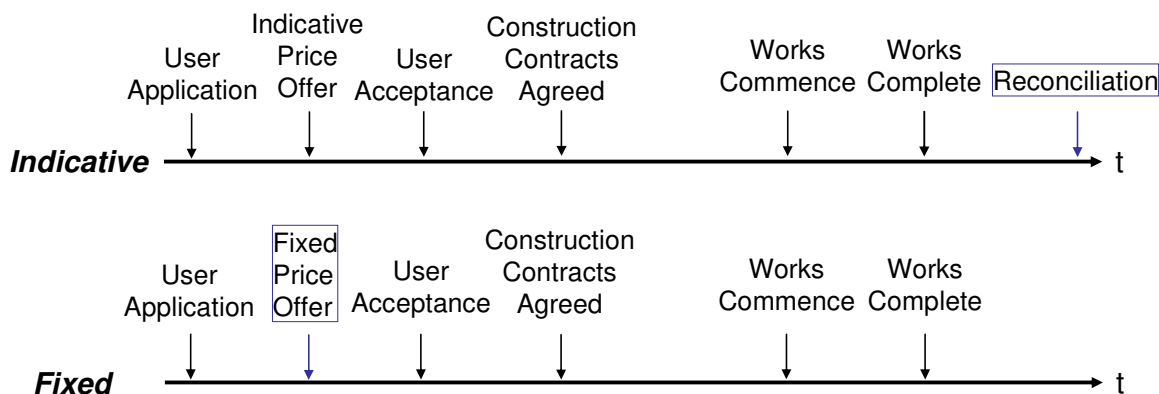
When users apply to the GBSO for a connection to the transmission system, they are able to elect whether the costs quoted in the offer are to be based on either “indicative” or “fixed” costs as described in Chapter 4 of the Statement of the Connection Charging Methodology (See Appendix A).

Under the current National Grid approach, an indicative offer means that the initial connection charge is based on National Grid’s fair and reasonable estimate of the expected costs at the point of issuing the connection offer. Then once the works are completed, and the actual costs fully known, the connection charge is reconciled during the “outturning process”. A fixed price offer means that National Grid

identifies a firm price¹ which the User then accepts at the offer stage. The Connection Charges are then based on this fixed price and are therefore certain at the offer stage and no reconciliation takes place when works are complete. All fixed price offers must take into account any associated risks and uncertainties and will therefore include a risk premium.

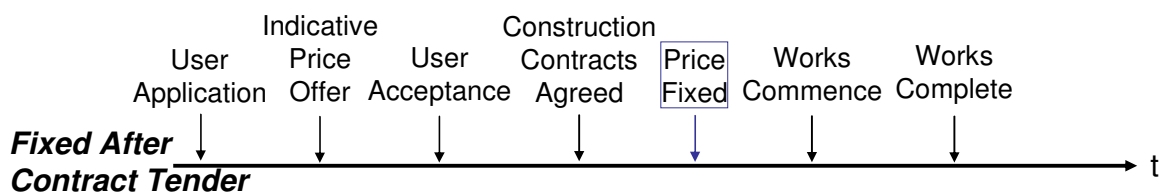
The diagram below outlines a timeline of the existing options .

Figure 1: Timeline of Existing Indicative and Fixed Price Options



The GBSO would like to understand User experience of the above price options, and in particular, whether the two price options satisfy User needs. There may be a range of possible alternative options which Users may like to suggest that would better fit their needs. One possibility is to provide a hybrid of the above by fixing prices after construction contracts have been agreed as shown in the timeline in Figure 2.

Figure 2: Possible Alternative Price Option, Price Fixed After Contract Tender



¹ Clause 2.11 of the Construction Agreement provides the GBSO with powers to revise charges if the scope of works change at any time prior to the Completion Date. This means that charges may increase if additions are made to Transmission Connection Asset Works and/or Transmission Reinforcement Works and/or the One-Off Works and/ or the Third Party Works and/or the Common Reinforcement Works. Similarly charges may decrease if works relating to the scheme are no longer deemed necessary.

The principle advantage of fixing prices after contract tender is that the primary price uncertainty surrounding construction costs are removed.

Clearly, each option will have a different risk profile both for the GBSO and the User. The table below attempts to briefly summarise the key advantages and disadvantages of each approach.

Table 1: Advantages and Disadvantages of presented price option types

	Advantages	Disadvantages
Indicative	<ol style="list-style-type: none"> 1. Final charges reflect actual costs incurred 2. Records of detailed costing data maintained 	<ol style="list-style-type: none"> 1. No price certainty to user or TO 2. Additional costs and bureaucracy of reconciliation process
Fixed	<ol style="list-style-type: none"> 1. Price certainty to User 	<ol style="list-style-type: none"> 1. Risk margin included in Offer charges
Fixed after Contract Tender	<ol style="list-style-type: none"> 1. Some price uncertainty removed 2. Avoids reconciliation processes 	<ol style="list-style-type: none"> 1. Risk margin included in Offer charges 2. Costs may change significantly between indicative Offer and price fix.

The Indicative approach provides a cost-reflective option to Users but also means that there is little price certainty for Users. In addition, the reconciliation process itself is not without cost since it requires careful cost capture and the necessary mechanisms to retain information over long time periods.

It can be expected that fixed price offers will include the highest risk margin to hedge against fluctuations in future construction prices given that some schemes take many years to complete, or even to commence works.

Some of the price uncertainty should be removed once contracts with construction companies have been agreed in the “*Fixed after Contract Tender*” approach. This means that a lower risk margin could be used in the offer price to Users. There would also be cost savings from the avoided reconciliation process.

Summary and Request for Feedback

This open letter has attempted to outline at a high level the main differences between the existing price options. The GBSO is keen to understand the needs of Users and to learn whether the existing arrangements are satisfactory. We would therefore welcome comments and feedback on the following questions:

1. As an applicant to the GBSO, do you have a preference for any of the pricing options as set out above?

2. What is the reason for your preference? i.e. what impact would each approach have in your financing options (if any)?
3. Can you suggest other pricing options that may be preferable?
4. Which combination of pricing options, should be made available to Users?

Please forward replies to:

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Alternatively, replies can be sent by email to:

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Responses received before 24th December 2008 will be considered in the review and any subsequent proposed changes will be subject to full consultation.

Appendix A – Chapter 4 of the National Grid Statement of the Connection Charging Methodology

Indicative Agreement

- 4.1 The standard connection agreement offered by National Grid is an indicative price agreement. From the Charging Date as set out in the User's Bilateral Connection Agreement, the User's initial connection charge is based on a fair and reasonable estimate of the expected costs of the connection.

Outturning the Indicative Agreement

- 4.2 Once the works required to provide a new or modified connection are completed and the costs finalised, the connection scheme is "outturned". National Grid reconciles the monies paid by the User on the indicative charge basis against the charges that would have been payable based on the actual costs incurred in delivering the project together with any relevant interest. This process involves agreeing a new charging GAV (The Base Amount) with the User in line with the elements stated in paragraph 2.3 and then calculating connection charges with this GAV.
- 4.3 In addition, for Users that have chosen MEA revaluation their MEA ratios are agreed at outturn and this ratio is used for MEA revaluation in subsequent years.
- 4.4 In the case of connection asset replacement where there is no initiating User, the outturn is agreed with the User at the site.

Firm Price Agreement

- 4.5 In addition to the options stated in paragraph 2.10 above, firm price agreements are also available. Typically with this option the charges to be incurred, and any indexation, are agreed between National Grid and the User and connection charges are not recalculated once outturn costs are known. A typical example of a firm price agreement is:
- Capital Contribution
 - Firm Price GAV
 - Running Costs (based on a firm price GAV)
 - Fixed Schedule of Termination Amounts
- 4.6 When a User selects a firm price agreement some or all of the above elements can be made firm. Any elements of the agreement that have not been made firm will be charged on an indicative basis in accordance with this statement.
- 4.7 Final Sums and Consents costs are never made firm in a Firm Price Agreement. Details of both are set out in the Construction Agreement.