APPENDIX 7.2

(referred to in paragraphs 7.36 and 7.45)

Generation component: adjustments for coal and nuclear premia

1. As explained in paragraph 7.36, in formulating a possible `adjusted yardstick' for the allowed generation cost, the DGES calculated the higher coal costs faced by the RECs (the coal premium) and the higher nuclear costs faced by HE (the nuclear premium). This appendix explains the nature of the calculations, HE's comments on OFFER's calculations, and OFFER's subsequent revisions to its estimates.

The DGES's price review calculations

2. The coal premium is a measure of the higher costs faced by the RECs arising from the `coal deal' contracts in England and Wales with British Coal (BC) relative to imported coal supplies. Based on data in the White Paper *Prospects for Coal*,[1] the DGES assumed a constant real price of imported supplies (delivered to a coastal station) of 117p per Gj (in 1992 prices) for 1995 through to 1997/98. These costs were then converted to p per kWh and apportioned in accord with the relative coverage of the coal contracts in the RECs' franchise market ([*] per cent). The coal premium used to calculate the nuclear premium was accorded a [*] per cent weight.

3. The DGES's estimate of the nuclear premium was based on the actual price charged by SNL to HE, less both a market-related `yardstick' price for nuclear energy and the extra income to HE from green ticket sales. The total market coal premium was deducted from the market-related yardstick for the purpose of this calculation.

4. The DGES's estimates of the coal and nuclear premia, as included in Table 7.8, were as follows:

p per kWh (in 1994/95 prices)

	1994/95	*1995/96*	*1996/97*	*1997/98*
Coal premium (55%)	[	*Figures omitted.*		
Nuclear premium		*See note on page iv.*		]

HE's comments on the DGES's calculations

5. HE commented that the DGES had over-estimated the size of the coal premium, but under-estimated that for the nuclear premium. On the former, HE claimed that the DGES had not allowed for the inland delivery costs of imported coal, which HE estimated to be [*], and had not taken into account HE's coal contracts with BC, which were based on a similar formula to that used in the England and Wales contracts. As given below, HE's own estimates, which were also based on data in the White Paper, suggested that the premium over the control period was negligible.

p per kWh (in 1994/95 prices)

	1994/95	*1995/96*	*1996/97*	*1997/98*
Coal premium	[	*		]

6. HE's revision to the coal premium affects the size of the nuclear premium (see paragraphs 2 and 3 above). HE also suggested that the DGES had not applied the coal premium correctly in his calculations.

[1]*The Prospectus for Coal: Conclusions of the Government's Coal Review*, Cm 2235, March 1993.

*Figures omitted. See note on page iv.

However, HE's main concern about the nuclear premium was that the DGES's methodology did not take account of possible fluctuations in SNL's output away from HE's base forecast values. HE estimated, by way of example, that if SNL output were at the 1992/93 level during the control period, this would add significantly to the costs faced by HE in supplying the franchise market.

The DGES's further comments and revised estimates

7. In response to HE's comments, the DGES told us that HE had renegotiated its contract with BC for the period under review, and that he regarded the new contract as having a more obviously commercial justification than the coal contracts applying in England and Wales. He accepted that its earlier calculations had not included internal delivery costs for imported or BC coal, but nonetheless considered HE's estimate of [*] for delivery costs of imported coal to be too high. The DGES revised his calculation of the coal premium adding his own estimates of 10p per Gj for delivery costs of imported coal and 15p per Gj for BC coal. The effect was to increase the size of the coal premium.

8. The DGES also accepted HE's suggested treatment of the market price of SNL output in calculating the nuclear premium, but saw no reason for assuming that SNL output would return to the 1992/93 level, and did not therefore consider that further revisions were necessary, other than that resulting from the revision to the coal premium. He also noted that, under the terms of the contract with HE, the average price of SNL output decreases as output increases above a given level. The DGES's revised estimates were as follows:

			p per kWh (in 1994/95 prices)		
	1994/95	*1995/96*	*1996/97*	*1997/98*	
Coal premium (55%)	[	*Figures omitted.*			
Nuclear premium		*See note on page iv.*			]

9. The estimates provided by the DGES were calculated on the basis of the forecasts of market prices and the level of HE's franchise sales which were used during the price review. At our request, the DGES also calculated revised estimates on the basis of HE's latest estimates of prices and sales which were included in its evidence to the MMC. To undertake this exercise, a number of assumptions were required on the value of some important variables. He told us that the numbers do not represent his view on these variables and that a more detailed analysis would most likely lead to revisions. His comments on the appropriateness of HE's latest forecasts of market prices and demand in its franchise area are summarized in paragraph 7.48. The DGES stated that, given these caveats, the figures below should be treated with caution. The outcomes of this further exercise were as follows:

			p per kWh (in 1994/95 prices)		
	1994/95	*1995/96*	*1996/97*	*1997/98*	
Coal premium (55%)	[	*Figures omitted.*			
Nuclear premium		*See note on page iv.*			]

*Details omitted. See note on page iv.