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Sonia Brown
Director, Transportation
Ofgem
9 Millbank
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10th March 2005

Dear Sonia

Re: Initial thoughts on enduring incentive schemes supporting the offtake arrangements

Thank you for the opportunity to comment on the above consultation document.

Statoil (UK) Limited (STUK) is an active participant in the development of a divested industry structure through the potential sale of one or more DNs by NGT. As such we would like to further contribute to the development of this process my making the following comments. Please note that our response is not confidential and can therefore be placed on Ofgem's website.

STUK believe that there should be robust incentives in place for both the NTS and DNs and they should cover interim and enduring periods. The purpose of these incentives should be to ensure that the NTS is able to release the maximum capability on its network from responses to demand signals and that the DNs book efficient levels of NTS exit capacity.

STUK are concerned about the assumption made in the document regarding the exit regime required in the post DN sale environment. Although significant work has been undertaken on this issue the final proposals have yet to be put forward by Transco. While Ofgem have outlined their final view of the exit regime the modification has yet to be raised by Transco and could differ from the Ofgem view. This has made it difficult to assess the likely impact that the incentives will have on Transco and the DN's. It may be more appropriate to develop the two elements in conjunction to achieve the best solution of exit arrangements and incentives. Setting one before the other may give rise to risks that one set of arrangement may limit the development of the other artificially.

It is also unclear what type of product Transco are offering to the market. Under the entry capacity arrangements Transco sells a firm financial right to capacity where Transco can allocate incremental capacity but choose how this obligation is met. For example they can choose to buy back at the same or other terminals or simply invest to provide the capacity. However they choose to respond to these requirements the baseline capacity remains the same. It is not clear what the obligation is on Transco at exit and the option available to them directly impact baseline levels of capacity at other sites thus substantially undermining the allocation process in the short term.

The proposed form, scope and duration of the NTS and DN enduring incentives schemes

STUK's primary concern in connection with the enduring incentives scheme is the issue concerning substitution. We do not consider it appropriate that baseline levels can be altered via substitution in the long term auctions. We would question Ofgem's statement (p. 60) that 'incremental NTS exit capacity and or NTS exit flow flexibility delivered by substitution and with revision to baselines, will deliver efficiency gains by signals provided through long term demand'.

Enabling Transco to determine whether incremental exit capacity is to be made available through either substitution or investment may be appropriate. However, it must not be assumed that all NTS offtakes have the same ability or mandates to participate in long term auctions, it is essential that end users maintain the right to choose the type of contracts they enter into. If Transco opt for making this additional capacity available through substitution, we believe this will cause significant problems for sites that do not participate in the long term auctions as their baseline levels would be reduced by other offtakes who are able to take a longer view in terms of booking exit capacity. Under such a proposal, a level playing field does not exist for all NTS offtake points. All offtakes points should be allowed to assume their baseline levels of capacity will be available to them irrespective of whether they participate in the long term or short term auctions.

In considering other issues associated with substitution, STUK consider it appropriate that if incremental exit capacity is made available through substitution, then Transco should retain 50% of the revenue derived from the incremental capacity made available and that the remainder should be passed back to customers. It is unclear from the document which commodity charge is being suggested by Ofgem, the TO or SO.

STUK agree that both the NTS and the DN incentives should be designed for five years as this is consistent with entry. However, we consider that the incentives should be reviewed after two years of that period instead of the proposed one year as this will provide the most appropriate time period in which to evaluate how the incentives are performing.

STUK consider it is suitable that an incentive should be in place for the DNs so that this removes any tendency for overbooking NTS exit capacity and NTS exit flow flexibility. It is necessary that incentive are in place so that the DNs are able to meet the 1 in 20 obligation by either efficiently booking NTS offtake rights, contracting for interruption and DN related investment

Ofgem are proposing to include an incentive for DNs with a key objective in ensuring that they efficiently contract for interruption by including the greater than 15 day interruption payment incentive. In this document Ofgem state that the 15 day interruption payment incentive should not be linked with the proposed reform of DN interruption, as noted by Ofgem in the conclusions document on the interruption framework. It is unclear to STUK how this DN enduring incentive can be finalised in July 2005 when the outcome of DN reform (planned for April 2006) is not known. STUK consider that it is more appropriate to consider these issues together so that final proposals for enduring DN incentives can be implemented.

The appropriate methodology to be used in defining baselines for both NTS exit capacity and NTS exit flexibility

The base line numbers provided in appendix 1 raise a number of questions that make it difficult to assess the most appropriate methodology. STUK are concerned that under some proposals interruptible sites are given no capacity. While this can be clearly assumed under an administered regime, as exists at present, where Transco have a right to interrupt for up to 45 days it is difficult to understand in the new regime as the nature of interruption changes for end users and other direct connects.

Under a previous regime an NTS direct connect could offtake gas with discounted transportation charges in return for allowing Transco the right to interrupt for up to 45 days. Their level of offtake was still defined by the site parameters and SOQ. In moving to a baseline defined firm product Transco would need to make some commitment to interruptible release. An important factor in assessing choices between firm and interruptible product is the likelihood of interruption and acceptable risk to the operation of the site. This is impossible to ascertain in any of the options except the 1-in-20 plus interruptible baseline levels.

Setting baseline levels of capacity at any of the firm only levels will incentivise Transco to increase interruptible curtailment rather than appropriate demand management through buybacks or investing in their network as interruption is a zero cost option to Transco.

It is unclear from the consultation document as to how the baseline levels for NTS exit flow flexibility will be calculated and on what basis? Currently a site has its exit capacity baseline calculated using the SOQ. It is therefore unclear whether baseline levels for flow flexibility will be determined at an offtake node level or will be set at a national level. Without an appropriate level of definition of the product it is impossible to comment on the appropriateness of incentives for flow flexibility.

Whether baselines should be defined as a constant or whether these should increase over time

STUK believe that being consistent with the entry process, baseline levels should not be constant for the period of the price control but that they should be amended to reflect any release of long term incremental capacity. Beyond the price control period they should be consistent with the last year of the price control.

The indicative baseline numbers provided by Transco

STUK would like to make a number of comments associated with the table as shown in Appendix 1. It is clear that the list of offtake nodes comprise of a number of end user sites, storage points, compressor stations, DN offtakes etc. It would be helpful if this table could be re-structured in such a way so that it lists all offtake nodes based on some form of categorisation, i.e. relevant offtake nodes could be shown under the category of ‘DN – Scotland’. This would help in identifying offtake nodes more clearly.

We are concerned by the treatment of current interruptible sites as shown by the indicative baseline data in the table. All interruptible sites (including storage) are assumed to have no firm baseline quantities. As we have stated above there are a number of problems with the proposals for setting the baseline levels of exit capacity relating to interruptible sites.

The proposed treatment of substitution and investment as part of the enduring incentive schemes

STUK consider the proposals in place for substitution still require additional thought and development. It is not appropriate that baseline levels can be reduced for an offtake if it does not participate in the long term auctions. We believe this to be discrimatory against those customers who are unable to assume a long term position with regards to capacity bookings. The baseline levels for an offtake node should be maintained until a within day basis. Proposals to reduce baseline levels during long term auctions will prevent the site from securing sufficient capacity either through allocation or through trading as under the current proposals, trades are not permitted above baseline quantities.

STUK suggest that as an alternative to this, Transco could earn revenues for making incremental exit capacity available through substitution, but in doing so, will agree to make available all baseline level up to the within day stage. If Transco required additional exit capacity to manage constraints, then the use of buy backs could assist in managing the system. This regime would be more consistent with entry capacity where Transco make risk assessments against the various options and the best method of maximising their revenue while maintaining the increased opportunity to substitute at NTS exit.

While STUK agree that incentives need to be in place on both Transco and the DN to ensure they efficiently manage their networks, as we have stated above STUK have a number of concerns with the form of the incentives outlined by Ofgem. STUK trust that our comments will be given due consideration and should you wish to discuss any aspects of this response further please contact me on the above number.

Yours sincerely,

Robert Cross
Regulatory Affairs Manager

* Please note that due to electronic transfer this letter has not been signed