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Dear Sonia

Initial thoughts on enduring incentive schemes supporting the offtake arrangements

NGT welcomes the opportunity to respond to this consultation on the enduring incentive schemes associated with the offtake arrangements. Recognising that the interests of the transmission and distribution businesses within NGT will not necessarily be aligned on this issue, we are submitting separate responses. This response contains the views of the distribution business.

We support the concept of incentive schemes covering both the release of Exit Capacity by the NTS and the cost of providing capacity by Distribution Networks. The purpose of these schemes is to align the incentives on network operators with those of the customer and encourage efficient investment across the wider NTS/DN system. The NTS scheme is designed to ensure an economic choice between substituting capacity from one offtake to another, building new capacity, making greater use of interruption/turndown on the NTS and accepting potential exposure to buyback of exit rights. In the case of the DNs the optimisation is between paying greater NTS exit charges, investment in the DN and the use of interruption. Clearly, to meet the goal of efficient investment across the wider system not only must both schemes operate effectively, but so must the interaction between the schemes. To this end, it is important that the schemes are compatible in as many ways as possible: e.g. both schemes should be of the same duration to ensure that both schemes will be replaced at the same time. We set out below our views, focusing in particular on any potential for the incentives to lead to sub-optimal investment.

Baseline Capability

The consultation identifies four options for determining the level of nodal capacity that the NTS will be obliged to offer: predicted 1 in 20 demand, predicted 1 in 20 plus interruptible demand, practical maximum physical capacity and theoretical maximum capacity. We support the setting of NTS baselines using the practical maximum physical capability. This is on the basis that the baseline should reflect the capacity that is actually available to be used. The resulting price signals would therefore reflect accurately the threshold at which incremental demand would trigger investment. Accordingly, we do not support using a baseline derived from 1 in 20 demands, as this is likely to result in capacity that is available for use being excluded from the baseline. Furthermore, assuming that the chosen baseline will be retained for the duration of the incentive scheme, 1 in 20 forecasts set at the outset will appear increasingly arbitrary in the latter years of the scheme.

The use of theoretical maximum physical capacity would set the baseline at each node ignoring demand at other nodes. We believe that this approach is less attractive as the baselines set would be likely to exceed those that can be delivered in reality, resulting in the risk of higher and more uncertain buy back costs. Whilst the NTS would have an incentive to manage these costs, they would ultimately be passed on to the consumer.

To ensure a smooth transition to the proposed regime it is important to ensure that, wherever possible, DNs have access to the same levels of exit rights that they currently enjoy. If exit rights are artificially restricted, there is a risk of triggering additional and unnecessary investment within the DNs. We consider that the use of the practical maximum physical capacity baseline would mitigate this risk.

Optimising between Interruption and Investment in DN/NTS

The purpose of the DN incentive scheme is to reward the DN for achieving an efficient outcome in terms of investment in the NTS/DN and the use of interruption. Ideally, under the scheme a DN would have an incentive to pursue the lowest cost solution regardless of whether it a contractual or asset-based solution, and whether the assets are designated transmission or distribution.

The consultation describes how a category of cost can be covered by the scheme in two ways:

- Directly. The costs are included it the scheme out-turn that is then compared to the target and the resultant incentive payment/charge is calculated
- Indirectly. The costs are excluded from the out-turn and hence have no impact upon the incentive payment/charge. However, the DN can then use part of the incentive payment to fund the costs.

We believe it is better to include items directly for two reasons. Firstly, comparisons between different categories of cost can be distorted by the actions of sharing factors, caps and collars. Secondly, a price control can effectively prevent items being covered indirectly. Consider the treatment of distribution charges under the present price control. If the revenue collected exceeds the allowed revenue, for example because customers choose to move from interruptible arrangements to firm, there is no benefit to Transco: the over-recovered money will simply be refunded the following year. Therefore, we believe that the scheme should recognise this additional revenue and offset it directly against the additional costs of investment and/or the purchase of NTS exit capacity. We believe that the scheme should cover all relevant costs directly:

- Cost of primary and secondary NTS exit capacity
- Forgone revenue from interruptible customers
- Compensation for interruption, or other arrangements that may be introduced by 2008 e.g. turndown contracts
- Cost of DN investment over and above the baseline (i.e. depreciation plus rate of return)

We note that the consultation document does not consider the second element, of forgone revenue from interruptible customers, and believe this to be an important omission as it distorts the incentive and creates a bias in favour of the use of interruption. We appreciate that the proposed requirement to introduce changes to the DN interruptions regime from 2006 introduces significant uncertainty into the future levels of forgone revenue. However, we believe that this could be accommodated by waiting until the new DN interruptions regime has been agreed before setting incentive scheme targets. Given this difference on the basis for calculating target values for the scheme, we offer no comment on the numbers included in Table 4.2.

Furthermore we believe that the exit arrangements for flow flexibility should be symmetrical, allowing DNs to sell capacity to the NTS as well as purchasing it. There are several networks that have more diurnal storage capacity than is required for their own current purposes and are therefore able to provide storage capacity to the NTS. If this investment is not to become stranded, then the arrangements must allow the DN to sell back to the NTS (and thus, indirectly, to those connected at other offtakes) on an equitable basis.

The consultation is silent on the question of what pressure the NTS will make available at each offtake. This an important issue because if the same volume of exit capacity is made available, but at a reduced pressure, the DN could be obliged to invest heavily in its network to maintain acceptable end consumer pressures. The exit regime therefore needs to recognise the importance of offtake pressure in system design.

As a final point the incentive scheme will not be operating in isolation and consideration will need to be given to the interaction of incentive payments, the throughput term in the price control and the remuneration associated with investments entering the regulatory asset base.

Setting of Caps, Collars and Sharing Factors for the Scheme

Given that the illustrative targets in table 4.2 vary in magnitude between DNs by a factor of over a hundred, to set caps and collars in absolute terms would not appear sensible. We therefore support Ofgem proposed method of setting caps and collars as a fixed percentage of the target.

As we are proposing that all cost categories should be covered in the scheme directly, the importance of a high sharing factor in avoiding distortion is no longer relevant. As a result Ofgem can propose a package of target, cap, collar and sharing factor to produce an overall scheme with the desired incentive properties.

Ex Ante or Ex Post Targets

We note the discussion of the merits of setting incentive scheme targets for the whole scheme at the outset, versus updating targets annually in the light of actual load growth, prices etc. Setting ex ante targets at the outset for five years based on predicted demands and exit capacity prices, in our view, represents an unacceptable risk to DNs. This is because the associated risk is:

- Asymmetric, in that as capacity requirements rise above the baseline then exit capacity prices
 paid would be expected to rise progressively reflecting associated investment costs, but will
 not fall below the base level if no investment is required. This asymmetry is then exacerbated
 by the fact that the DN is exposed to the product of demands and prices.
- Cumulative, in that an unexpectedly large increase in demand and/or prices in one year will greatly increase the chances that demand/prices will be higher than expected the following year
- Largely driven by the level of demand, giving the DN a financial exposure to a factor that it cannot control
- Exit capacities will be affected by changing flows on the NTS, for example the injection of large quantities of gas at Milford Haven will increase the exit capacity available locally. These changes cannot be predicted accurately for all system offtakes over a five-year horizon.

Given the high level of risk, we believe that attempting to set targets for five years is very likely to result an outcome in later years beyond the incentivised range, defeating the purpose of the scheme and leaving one party looking to re-open the scheme. We believe that the risk can be contained, and the complexity of ex-post targets avoided, by setting the demand levels and prices used in calculating the targets ex ante but for one year at a time. It may be possible to move to longer term targets once both parties have experience of how the scheme will operate in practise. It is important that the forecast demand used should be the 1 in 20 demand as this reflects the level of capacity that the DN is obliged to book.

Substitutions

Ofgem propose a system whereby the NTS can provide additional capacity by switching, or substituting, capacity from an Offtake where there is a surplus, to one where there is a shortage. Clearly, this would be more economic than investing in new capacity. Whilst we support the concept of exit capacity being substituted, a clear methodology needs to be established as to which node the additional capacity will be taken from. It is proposed that the NTS will benefit whenever capacity is substituted from one node to another in order to meet customer demand. In the absence of a clear methodology, the NTS will have an incentive to take capacity from a node where they believe that there is a high likelihood of future growth so that they can then benefit from substituting capacity back to that node at a later date. Conversely, the NTS will have less incentive to reduce the exit capability at a site where growth is unlikely, as the chance of being rewarded for substituting the capability back at some point in the future will be correspondingly small.

Clearing allocations

In a clearing allocation, a reserve price of zero is used, if necessary, to minimise the volume of unsold rights. As exit capacity is a nodal product clearing allocations should be restricted to the few offtakes that have multiple connectees. Even here, in the short-term the capacity available is liable to exceed demand and so participants could wait until the clearing allocation before entering a low bid for the required capacity. In the interests of an orderly market, with participants signalling their requirements in a timely manner, we support the use of consistent reserve prices in all time scales rather than requiring a clearing allocation.

Test of "Sustained Demand"

The consultation identifies the need for a test to determine whether the NTS should be obliged to release incremental capacity that has been requested. With the depletion of gas reserves on the UK Continental Shelf, demands for gas exit capacity will tend to be more stable than for gas entry. It follows that there is a reduced risk of stranding and a simpler test for whether or not demand should be considered as sustained is appropriate. We support the proposed test that any request for capacity for a period of at least three years would result in the release of permanent incremental exit capacity.

Duration of Schemes

We support, in principle, the proposed duration of five years to provide a period of certainty against which to invest. However, as the proposed baselines assume system reinforcements accepted in the main price control, it will be problematic for the incentive scheme to extend beyond the end of the price control in 2011/12. As we approach the end of a scheme, the period of certainty will become short and it may be helpful to have a common understanding of what changes are likely to be introduced in any replacement scheme.

We note the proposed opportunity to re-open after one year, but need further details on how the reopener would be triggered and what the implications would be before we are able to comment.

Maintenance Rights for NTS

The NTS will need access to their equipment at offtakes for maintenance purposes and this will reduce the exit capacity available during the work. However, each DN will be relying on its holding of exit rights to demonstrate its compliance with its safety case. It is therefore essential that a DN consents to any reduction of its exit rights to allow for maintenance on the NTS, rather than having such a reduction imposed upon it. Whilst this could be achieved by obliging the NTS to "buy-back" exit rights, generally the holder of the rights would have a monopoly that could be exploited. We propose that the NTS should have an allowed period of maintenance access, provided the timing of the access has to be agreed with the owner of the access rights.

To summarise, we believe that there are three issues that are key to achieving the objectives of the incentive scheme:

- The baselines offered by the NTS should reflect the system capacity available. If this is not the case, it is unlikely that the objective of using capacity pricing to optimise investment across the distribution and transmission networks will be achieved.
- To provide a DN with the correct incentive to optimise holding exit capacity, investing in its own network and using interruption/turndown all the cost elements need to be included within the incentive scheme directly.
- There is too much uncertainty to set targets for the duration of the scheme at the outset. The incentive properties of the scheme are negated if the targets for later years are unrealistic and the DN will either be at the cap or collar.

I trust that you find the above comments helpful in developing these incentive schemes. If you would like to discuss any of the points raised, please do not hesitate to contact me.

Yours sincerely

By E-Mail

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