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Dear Sonia

Please find attached a copy of the National Transmission System response to Ofgem's initial thoughts on enduring incentive schemes supporting the offtake arrangements

Yours sincerely

By e-mail

Elaine Calvert  
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## **NGT transmission business response to Ofgem's initial thoughts on enduring incentive schemes supporting the offtake arrangements**

### **Executive Summary**

We welcome the opportunity to respond to Ofgem's, initial thoughts on the enduring incentive schemes supporting the offtake arrangements. This response is written on behalf of the National Transmission System (NTS).

We note Ofgem's stated objectives in relation to the incentive regime, outlined in the document:

- the NTS has incentives to deliver the full physical capability of its network;
- the NTS has sufficient funds within the relevant price control period to undertake appropriate investment above baseline levels (in response to enduring demand signals); and
- the NTS has an incentive to buy back NTS offtake rights in order to relieve network constraints in an efficient and economic manner.

It is our view that the incentive regime should ensure that Transco's use of investment on the NTS is efficient and economic, whilst recognising the need to provide Transco with the correct balance between risk and reward given its position as a regulated monopoly.

In relation to the proposed methodologies to be used in defining baselines, we believe the only methodology that would effectively meet the objectives of the incentive regime would be to set these to reflect the forecast 1 in 20 firm demand. This methodology is consistent with the way in which we plan our system to meet the anticipated 1 in 20 peak conditions and the way in which we are funded through the price control. We also believe that the practical maximum physical capacity methodology may meet the objectives if the entry UCAs were set such that they would cover any entry investment needed to support these exit baselines. However, whatever the methodology chosen for setting baseline capacity, it is vital that there is consistency between that methodology and the setting of the buy back pot.

In relation to the setting of UCAs, the purpose of a UCA is to provide the best estimate of the marginal cost of investment at a particular point on the system such that it would provide Transco a suitable amount of incremental revenue for providing extra capacity on the system at that location. Given the ongoing changes in supply and demand for gas, we strongly suggest that UCAs (both for exit and entry) should be amended on an annual basis.

Finally, we believe that curtailment of exit capacity and flow flexibility entitlements to allow maintenance to take place, should be specifically excluded from the incentive schemes and that a regime akin to the present Network Code entitlements should remain.

Therefore, we would welcome further discussions with Ofgem, to turn these initial thoughts into Initial and then Final Proposals that would ultimately provide Transco with the correct balance between risk and reward. In relation to the structure of this response we have provided detailed answers to each of the questions in relation to the NTS raised by Ofgem in Chapter 5 of their initial thoughts document.

### **The proposed form, scope and duration of the NTS incentive scheme**

In general, we support the proposed form and scope of the NTS incentive scheme. Given the interaction between the entry and exit regimes, we believe that a four-year scheme to 2011/12 would be beneficial, permitting the incentive regimes to be synchronised with the main price control review.

However, we would welcome confirmation from Ofgem as to the way in which funding for any incremental capacity would be made, in particular the interactions between the TO and SO controls. We note, in paragraph 4.17, that Ofgem states that it wishes to set incentives on the NTS to provide incremental exit and NTS flow flexibility by investment on the NTS, which are consistent with those in place for entry. However in paragraph 4.22, Ofgem also states "... Following this five year period, efficiently incurred investment could then enter the RAV ...". This implies that there is no remuneration through the TO control for the period of the SO incentive payments. This is not necessarily the case for entry where, depending on the timing of the obligation to release capacity and the forthcoming price control review, funding could be remunerated partly through the SO (up to the UCA amount) but also through the TO control (the difference between the efficiently incurred actual capex and the UCA deemed amount) – see, for example, Appendix 2 within the Ofgem's consultation for new entry terminals to Transco's National Transmission System<sup>1</sup>. If this were not to be the case, we would welcome further discussions with Ofgem on how the interactions will be dealt with under the new exit regime.

In relation to the duration of the NTS exit incentive scheme, in general, we do not support price control re-openers. However, given the considerable uncertainty, particularly in relation to the flow flexibility product, we believe that it may be appropriate to review the arrangements at an early opportunity.

## **Methodology to be used in defining baselines for NTS Exit Capacity and flow flexibility**

We agree with Ofgem that one of the primary objectives of the incentive schemes is that Transco should be incentivised, through an efficient balance of risk and reward, to offer for sale the maximum capability of the network. The setting of appropriate baselines is a vital component of meeting this objective. In relation to the potential approaches for enduring NTS exit baselines, we have considered the four broad alternatives for setting baselines outlined in the document and our thoughts on each are outlined below:

### **Forecast 1 in 20 firm demand**

It is our firm view that defining baselines consistent with the forecast demand expected to arise on the network under 1 in 20 conditions would be the most appropriate methodology to adopt. This proposed methodology is both consistent with the obligation Transco has to provide a network capable of conveying gas to those consumers expected to consume gas on a 1 in 20 peak day as is stated in Ofgem's document. In addition the methodology for setting baselines in this manner is also consistent with the funding received through the TO price control.

Clearly, as Transco is obliged to plan the system to meet the 1 in 20 obligation, we believe this methodology best reflects the capability of the system.

### **Forecast 1 in 20 demand plus interruptible demand**

When considering the approach of forecast 1 in 20 demand plus interruptible, we presume that Ofgem means that Transco should have an obligation to offer for sale as baseline exit capacity, a level equal to the forecast 1 in 20 demand plus interruptible as firm rights. This proposed methodology presents difficulties in that, as previously stated, we have designed our network in line with 1 in 20 firm demand only. The approach of having an obligation to release 1 in 20 firm demand plus interruptible as firm rights could lead to significant buybacks on parts of the network and would not be consistent with the way in which the TO price control has previously been set. This means that either the NTS would need a significant buy-back pot or was sufficiently remunerated through its TO price control, to meet this level of obligation.

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<sup>1</sup> New entry terminals to Transco's National Transmission System: Ofgem's views on Transco's proposals and Explanatory notes to accompany the section 23 notice of proposed modifications to Transco's gas transporter licence." – June 2003

## **Practical maximum physical capacity**

The approach of practical maximum physical capability takes into account the interaction between nodes. The baselines proposed under this methodology could be greater than those under a forecast 1 in 20 firm demand upon which the system is designed. We appreciate the logic behind this methodology; however, we believe that certain practical issues would need to be addressed. We note that the numbers provided via this proposed methodology are based on 12% higher demands than those under the forecast 1 in 20 firm demand methodology. As such the NTS would receive no incremental revenue through the exit incentive for accommodating this additional demand. It should therefore be recognised that to support this increased level of demand there would be associated incremental costs at entry. Were these costs to be appropriately remunerated through the entry investment incentive mechanism, we believe that this approach to setting baselines would be suitable.

## **Theoretical maximum physical capacity**

The approach outlined for theoretical maximum physical capacity is inappropriate. The baselines proposed under this methodology are way beyond those the system can presently handle. As such, it is our view that were this methodology adopted, Transco should

- either be funded for the required investment to meet these increased baselines; or
- be set a buyback pot at a significant level for several years in order to enable Transco to make the appropriate trade offs.

We believe that this approach would also remove the notion of scarcity and as a consequence, market participants have no incentive to signal long term demands in situations where those demands would be in excess of actual capability but below the baseline obligations (as has been recently illustrated in the case of entry). Furthermore, this proposed methodology also makes any possibility of substitution highly unlikely.

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

The important point on this issue is that there should be consistency between the way in which the baseline moves over time and the basis on which the successive price controls are set.

## **The indicative baselines provided by Transco**

We provided to the best of our ability, a true and correct representation of the indicative baseline numbers, for which we were asked, based on the methodologies suggested by Ofgem.

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

We strongly believe that we should be positively incentivised to meet requests from shippers/DN Operators for incremental capacity through the use of existing capacity before investing in and building new infrastructure. We welcome the concept of substitution, by node, whereby baseline NTS exit capacity and NTS exit flow flexibility can effectively be allocated from one offtake point to another and believe that we should be provided with strong incentives that enable us to satisfy demand for capacity innovatively. The benefit to end consumers of providing incremental capacity via substitution will be substantial, compared to the full costs of building new infrastructure. We therefore believe that Transco should be highly incentivised to meet incremental capacity release through this mechanism.

However, we consider that the proposed incentive, whereby the NTS is allowed to retain fifty per cent of the auction revenue received for incremental capacity for one year does not provide a significantly strong incentive for Transco to choose substitution over investment. This is because it would provide only a small incentive for Transco to invest in new technology or systems to enable Transco to satisfy demand in this manner, particularly given that Transco would only receive the revenue for one year.

We would welcome further discussions with Ofgem on the maximum cap level to be placed on incentive payments that may be earned by the provision of incremental NTS offtake rights through substitution and the proposed adjustment of baselines following substitution.

As previously mentioned in our response above to the issue of setting baselines, we believe that substitution will only be useful if baselines were set at a level such that we would see signals for incremental demand.

## **The proposed approach to the setting of UCAs for NTS offtake points**

In relation to the development of incentive arrangements, we agree with Ofgem that the NTS should be incentivised, through an efficient balance of risk and reward, to release for sale the maximum capability of the network (in response to demand) and to ensure that the DNs book an efficient level of NTS exit capacity and NTS exit flow flexibility.

Fundamental to the development of the incentive regime is the appropriate setting of UCAs. The main function of the UCA is to reflect, as accurately as possible, the marginal cost of investment at a particular point on the system. In doing so, it would then provide an amount of incremental revenue to Transco sufficient to cover the costs incurred in providing incremental capacity at that particular point.

We note Ofgem's comment that the methodology for calculating UCAs for NTS offtake points should reflect that used for entry points. We agree that the methodology used for entry should be followed for exit, i.e. using the Transcost model as the basis for setting exit UCAs.

However, in light of our experience of operating under the entry regime, we believe that the process for setting UCAs has considerable scope for improvement so that market participants face the correct market information against which to signal their demand. In particular, we believe that UCAs for NTS offtake points should be revised annually. For entry, UCAs are presently set for the duration of the price control. Over time, the configuration and capacity of the network and the costs of constructing new capacity change, meaning that the UCAs are less reflective of the costs of providing new capacity. This divergence between the UCAs and the actual costs of investment means that incorrect signals are given to market participants, and the incremental revenue received by the NTS for providing incremental capacity poorly reflects the actual costs incurred. In addition, if UCAs are fixed for the price control period, there are likely to be large step changes in UCAs from one price control to the next, reflecting five years of changes in the network and construction costs.

By revising UCAs annually, they will provide a more accurate reflection of the marginal cost of investment. This would then provide more appropriate signals to market participants of the incremental cost of investment at each point on the system, and more appropriately remunerate the NTS for providing new capacity. Annual revision would also remove the step change in UCAs between price controls. In addition, if reserve prices, which would apply to baseline quantities of capacity, were set using the same methodology as for entry (i.e. consistent with the UCA), an annual revision would avoid the need for large price variations.

Whilst the comments above relate to the setting of UCAs for NTS offtake points, we believe that they also apply to the setting of UCAs for entry, and the entry methodology should be revised at the

next price control to allow the annual revision of UCAs, and to ensure that the exit and entry regimes are fully aligned.

## **The way in which maintenance costs should be handled in NTS enduring incentive schemes**

We believe that curtailment of exit capacity and flow flexibility entitlements to allow maintenance to take place should be specifically excluded from the incentive schemes and that a regime akin to the present Network Code entitlements should remain.

Whilst it is true that Transco is required to buy back entry capacity where necessary to conduct maintenance at beach terminals, the analogy with exit is limited. This is because, in particular:

- At entry, there is generally duplicate pipework or the ability to source gas from elsewhere or overflow where this is possible which normally allows maintenance to take place without affecting terminal or sub-terminal end of day flows. This is not the case at exit points where, by way of example, complete cessation of flow is normally required to verify that a valve will seal upon closure.
- Unlike at least most entry points, it is doubtful that multiple market participants will be present at exit points. At entry, to a greater or lesser extent, depending on circumstances, there is some competition amongst market participants to offer capacity back to the NTS. This provides an element of price competition and enables the NTS to buy back capacity at a price determined by the market. We do not believe that this degree of competition would exist at exit.
- Maintenance at exit is also subject to statutory requirements, meaning that we are more likely to be in the position of a distressed buyer of exit rights, i.e. we may need to buy back the capacity at whatever cost is demanded by market participants which, given the arguments above for exit, may not be subject to the same competitive pressures. Furthermore, rights to undertake exit maintenance are clearly set out within Transco's Safety Case and any proposed amendments to the present arrangements would be subject to material change to this document being approved by the Health and Safety Executive.

In our view, the proposed exit capacity buy-back regime can only deliver economic and efficient outcomes to the extent that feasible alternatives exist. In the case of buy-backs to manage exit capacity constraints that may arise on the system, these may be considered in the form of pipeline reinforcement, turn-up from storage or turn down of downstream demand. However, in the case of maintenance, the only real alternative would be to build by-pass pipelines at all exit points to accommodate very infrequent gas flows, which may be perceived as inefficient and uneconomic.

Based on the above, NGT considers that the logical position is to exclude maintenance from the exit incentive.

## **Clearing allocation**

We note that Ofgem has asked for comments regarding an obligation on the NTS to offer exit capacity and NTS exit flow flexibility for sale in at least one "clearing allocation." Transco firmly believes that it is inappropriate to place such an obligation on the NTS, as having to offer capacity for sale with a zero reserve price would undermine the auction process and lessen any signals received via long term auctions, given that at most locations there is only likely to be one purchaser.

This could lead to a potential windfall benefit to players at these locations that then must be financed through an increase to charges to all other players if the level of the maximum allowed revenue remains unaltered and is to be collected. This situation would be further exacerbated

were Ofgem to choose one of the methodologies, which resulted in the NTS having an obligation to offer high levels of baseline capacity.

Indeed, recent experience from entry has shown that since the move to offer zero priced capacity on the day, willingness by market participants to commit to capacity sales in the long term auctions has greatly reduced, thus reducing the likelihood of Transco receiving meaningful investment signals. This experience confirms the view expressed by Transco at the time of the last price control that this obligation should not have been placed on the NTS for entry.

## **Conclusion**

We hope that these comments are useful and we look forward to working with Ofgem over the coming weeks to agree a suitable way forward on the items raised in this response and thereby, deliver appropriate enduring incentive arrangements for the NTS.