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30 June 2005

Dear Nienke

Please find attached a copy of the NGT transmission business response to Ofgem's consultation on new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs).

As ever I would be happy to discuss any elements of the response with you or members of your team.

Yours sincerely

By e-mail

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NGT transmission business response to Ofgem's consultation on new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs)

Executive Summary

We welcome the opportunity to respond to Ofgem's consultation on new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs). This response is written on behalf of the NGT transmission business, and as such we have not commented on Chapter 6 (Entry points connecting to DNs).

Ofgem last consulted on UCAs in November 2003 in relation to the Garton NTS entry point and since that time a number of issues have arisen in relation to the setting of UCAs at new entry points. This consultation raises several fundamental questions in relation to the entry regime including, but not limited to, the frequency of updating UCAs, the LRIC modelling assumptions, price stability and certainty afforded to shippers, developers and producers, and the methodology for the setting of reserve prices. We are therefore extremely keen to be fully involved in working through the implications associated with taking forward any proposals resulting from the consultation.

Our main comments concentrate primarily on the principles behind setting UCAs, and the timing associated with implementing those principles for both new and existing entry points. In relation to timing, we recognise Ofgem's point that as a number of developers are interested in establishing new gas storage sites that would require connection to the NTS, there is no 'do nothing' approach, for new entry points. We therefore recognise that UCAs need to be set for these new entry points at this time. We also recognise that Ofgem are consulting upon the treatment of existing entry points and we identify the issues we believe are relevant in respect to UCAs at existing entry points.

The overall structure of the response concentrates, in this executive summary, on the principles associated with setting UCAs and the immediate issues associated with Ofgem's two potential options for dealing with new and existing UCAs in the immediate future. Our views on the more detailed questions contained in the consultation document are then attached as an Appendix.

<u>Principles associated with setting UCAs</u>

We note within the consultation that Ofgem has identified a number of draft principles for setting UCAs, which are set out below.

- UCAs should reflect long-term costs, be non-discriminatory and facilitate competition between shippers and suppliers;
- UCAs should not create perverse incentives, including for the uneconomic bypass of Transco's network;
- UCAs should be set in a timely way so not to frustrate the legitimate expectations of project developers;
- UCAs should be set via a transparent process and informed by consultation and expert advice.

We believe these principles are sound and form a good basis for assessing the setting of UCAs both in the medium term and for setting UCAs for the 2005 long-term entry auction.

In addition to Ofgem's principles set out above, we also believe that it is important that the UCA should provide sufficient incremental revenue to cover the costs incurred by Transco NTS in providing incremental capacity.

On the immediate issue of setting UCAs for new and existing points in this year's long term auction, we note Ofgem is considering the following two potential options:

- Option 1 – recalculation of all existing UCAs together with the new entry points
- Option 2 – capping the new entry points to the level of UCA at a nearby existing entry points, whilst leaving existing UCAs unchanged.

Our assessment of whether the options meet these principles is set out below.

Option 1

We believe that Option 1 meets Ofgem's draft principles, as the resultant UCAs would be cost reflective, would promote competition and would be non-discriminatory. In addition we believe that setting UCAs on a cost reflective basis would not lead to any perversities, which could result from adopting Option 2. We believe these principles are important principles in relation to setting UCAs. In addition if UCAs are set in a cost reflective way they should ensure that the UCAs provide sufficient incremental revenue to cover the costs incurred by Transco NTS in providing incremental capacity.

We also recognise, however, that Option 1 is likely to have an adverse effect on price stability and certainty afforded to shippers, developers and producers. The impact of each option in providing regulatory certainty to developers, shippers and producers will therefore need to be considered in determining the appropriate treatment of UCAs for existing entry points. In particular, consideration should be given to the relative importance of price stability in attracting new gas supplies into the UK. It is therefore for consideration as to whether there was previously an expectation that the UCAs, and the associated link to reserve prices, would remain fixed at least until the next price control period.

Option 2

In contrast to Option 1, we believe that Option 2 does not meet the draft principles set out above. In particular, given this option is not cost reflective, it is likely to result in potential cross subsidies between customers and is unlikely to ensure that the UCAs provide sufficient incremental revenue to cover the costs incurred by Transco NTS in providing incremental capacity. Option 2 is also likely to provide some perverse incentives in this year's long term auction as it would provide incentives on certain customers to lock into long-term capacity rights at sites where the costs are below the cost reflective UCA. Option 2 does, however, clearly have the benefit of providing some further certainty to shippers, developers and producers at least until the next price control.

In addition to the points raised above, we would note that although this option may appear to treat new and existing entry points in a similar manner, it would not be consistent with previous regulatory decisions for new entry points. We also note that setting UCAs in line with Option 2 is subjective as to the nearest existing entry point to be used as a reference

value. Finally it is questionable as to how this option would allow Transco to meet its broader licence conditions such as Standard Special Condition A5 5 (aa)(I), which relate to the objectives associated with setting reserve prices.

In summary we believe having assessed both the options against the draft principles, that Option 1 is the more appropriate method for setting the UCAs for both existing and new entry points. We recognise however that there are potential, mainly practical, issues associated with implementing Option 1. In the event that Ofgem, as a result of this consultation, were minded to proceed with Option 2, we would want to ensure, through discussions with Ofgem, that Transco was not exposed to a revenue shortfall through setting non cost reflective UCAs in advance of the next price control. In addition, we would be seeking comfort from Ofgem that Option 2 was not inconsistent with the above licence condition.

Potential issues associated with the timing of the 2005 long-term entry auctions.

In addition to the points raised above we believe that there is one further factor that needs consideration in relation to the options for setting UCAs, namely the impact of any decisions resulting from this consultation on the subsequent timing of the 2005 long-term entry auctions. In particular we would need to consider whether there would be sufficient time to respond to capacity requests from October 2008 onwards if auctions were held later than September. We recognise that the lead times associated with delivering entry capacity is a topic upon which Transco has recently consulted as part of the IECR methodology consultation. We therefore believe that the Transco recommendations from the IECR methodology consultation should also be considered in reviewing comments on this consultation.

In the meantime given the uncertainties surrounding the timing of this year's entry auctions we would encourage customers who may be requesting incremental capacity from 2008 to contact us so that all options can be considered in order to try and facilitate the requests. We would also want to discuss any potential buyback implications associated with running the auctions later in 2005 with Ofgem.

Finally we would also need to consider whether it is likely to be necessarily to undertake a charging methodology review as a result of this consultation. Our current view is given the Ofgem consultation covers the interaction between UCAs and reserve prices that it may not be necessary in all circumstances to undertake a charging methodology review. However, as noted in the attached Appendix, it may be necessary to undertake a charging methodology review to deal with the potential under recovery associated with revenues that could result from auctions with UCAs set on the basis of Option 1. Clearly the interaction of Ofgem decisions relating to this consultation document, any potential consultation on the related charging methodologies and the timing of the 2005 entry auctions will need to be fully understood and considered.

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.

NGT transmission business response to Ofgem's consultation on new entry points, reserve prices in auctions and unit cost allowances (UCAs)

Appendix

We welcome the opportunity to respond to the views invited within Ofgem's consultation document. Within this appendix we have answered the questions raised by Ofgem in chapters 3, 5 and 7 and have also responded to the broader questions outlined by Ofgem in Appendix 3 – Draft Impact Assessment, of the consultation.

Chapter 3 - A method for setting LRICs and UCAs

Overall approach to modelling LRICs and UCAs identified in the chapter

In order to estimate long run incremental costs (LRICs) for any given entry point it is necessary to make a range of assumptions and model the flows of gas across the NTS. Ofgem asks whether Transcost or Graphical Falcon is the most appropriate model. It is our view that when considering whether or not to continue using Transcost or alternatively employ Graphical Falcon, the most important discussions should relate to the assumptions that underlie the estimates of long run incremental costs, rather than the technicalities of the individual models. Therefore, the assumptions of the supply/demand scenario and the baseline used to model the costs become the most influential elements in the modelling. In addition, as with all long term planning network models, there needs to be an assumption that the forecast supply matches the forecast demand.

However, we believe that Ofgem's assumptions that supplies should be set to the minimum of either the sum of the baseline plus any auction signals for incremental capacity or the 1 in 20 demand is not consistent with the obligations placed upon Transco within its NTS GT licence to release entry capacity up to the baseline level and to plan to meet 1 in 20 forecast demand levels.

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. In so doing, it should determine an amount of incremental revenue to Transco sufficient to cover the costs incurred in providing incremental capacity at that particular point. We believe that UCAs can only be deemed to be cost reflective if it is clear which incremental costs they are reflecting.

Steps 1 to 6 identified at the start of the chapter

In light of our experience operating under the entry regime, we believe that the process for setting UCAs has scope for improvement so that Transco is correctly remunerated for its costs and market participants face the correct market information against which to signal their demand.

Presently, the way in which UCAs are set means that they can become less reflective of the costs of providing the new capacity. This is due to the fact that over time, the configuration and capacity of the network and the costs of constructing new pipelines change (for example, recent increases in steel prices have seen project costs increase greatly), meaning that after a five year period the UCAs are less reflective of the costs of providing new capacity. This divergence between the UCAs and the actual costs of

investment means the incremental revenue received by Transco NTS for providing incremental capacity poorly reflects the actual costs incurred and lost cost reflective signals are given to market participants.

With regard to our licence obligations, we believe that prices should be set on a cost reflective basis in order to promote competition. With this in mind, we believe that reserve prices should be set to be consistent with UCAs as long as the UCAs themselves are cost reflective.

Due to the length of time that has elapsed since the licence UCAs were set and the ongoing changes in supply and demand patterns, it is evident that there will be large step changes in UCAs for the existing entry points. The revised UCAs (and hence revised reserve prices) are likely to lead to significant under-recoveries in entry capacity auctions. We would therefore seek to consult on the appropriate way to reflect this in our charging methodology. For example, it may be necessary to consider some form of non-locational capacity charge or look to extend the current TO commodity charge to deal with large under-recoveries from auctions. Further to the above, we do not believe that Transco would need to consult on a change to the current charging methodology as Ofgem has already consulted on reserve prices within this consultation.

In order to avoid the strong possibility of a similar situation arising in the future, we suggest that in future, UCAs (both for entry and exit) should be amended on an annual basis, as they would then provide a more accurate reflection of the marginal costs of investment over the entire price control period. It would also ensure that an opportunity exists at least once a year to incorporate new entry points. However, we recognise that it may be more appropriate to consider this issue as part of the next price control review.

Approach to use the lower of 1:20 or the baseline where there is no appropriate auction signal

As previously mentioned in our response to the overall approach to modelling LRMCs and UCAs, the assumptions that underlie the supply/demand scenario, including the method of incorporating the baseline levels, become the most influential elements in the modelling.

Under any particular scenario for supplies, the LRMC reflects the marginal cost of providing incremental capacity above that assumed supply scenario. As such, were the supply scenario assumptions to change by any significant amount, the resultant LRMC would also change.

This effect can be illustrated by comparing the UCA for St. Fergus that was set at the time of the last price control (£0.7040/kWh in 2004/5 prices) with the UCA, which has now been calculated using the methodology outlined within the consultation document (£0.0000/kWh). This change in estimated LRMC is primarily driven by the current assumption that supplies will reduce over the next 10 years at St. Fergus, meaning that the cost of providing incremental capacity over that reducing supply level will be very small, as the capacity has already been provided.

The only way to avoid these variations in LRMC would be to keep the supply assumptions at a fixed level, so that the marginal cost would always be referencing the same base assumptions. We believe that this is an important issue which warrants further discussion and consideration as part of the next price control.

Appropriateness of using load absorption to balance the network and if not considered appropriate, which approach(es) might be better and what are the advantages and disadvantages of using these approaches;

The LRMC process for price setting purposes has historically used 2.834 mscm/d (100 mscft/d). Due to the nature of the system, increases in entry or exit flows at a number of points in a similar locality will result in flows passing through a common feeder. As a consequence, an incremental volume based on approximately 10% of typical feeder flows was identified as the minimum required to generate appropriate marginal cost estimates. The value of the increment was never meant to represent the expected increase in demand at any individual exit point or the expected size of any new entry point but to be sufficient to calculate robust LRMCs. We recognise, however, that for new entry points with expected flows significantly in excess of this minimum incremental volume, there may be economies of scale that could be reflected by calculating the relevant UCA based on a larger increment size. We therefore believe that using 2.834 mscm/d should be the minimum increment size used, but would welcome further discussions on this and the assumptions that underlie each of these models, such as the supply/demand scenarios and the structure of the commercial model upon which any model is based.

10 year modelling timeframe in order to determine LRICs

Ofgem asks whether LRMCs should be based on a ten year modelling timeframe. We do not believe it to appropriate to change from a ten year modelling timeframe in relation to running the auction this year. We currently use a ten-year timescale as we produce an annual ten-year statement in line with Transco's licence obligation Special Condition C2. However, we would welcome further discussions in relation to the timeframes used to determine LRICs as part of the price control review.

Advantages and disadvantages of using Transcost and whether there are more appropriate models, which might be used, and the advantages and disadvantages of such models

Transcost uses the same base network as the engineering model (Graphical Falcon) that is used to inform investment decisions on the network. However, Transcost uses a number of simplifications to facilitate the processing speed. These include a simplified panhandle pressure loss equation with fixed temperature and gas quality factors. Transcost also limits the reinforcement options to additional compression units at existing compressor stations and equivalent pipe diameter duplication. Given a base network including machine settings, ten-year supply and demand scenario and investment cost data, Transcost can be used to analyse the cost implications of incremental flows for every combination of NTS entry and exit point within an hour. Engineering models, such as Falcon, would require a number of hours to carry out the analysis for a single route with much User input. When Falcon was used for the LRMC process only a small sub-set of the routes were analysed with the remainder of the routes manually interpolated, as would be the case with alternative engineering design models. NGT is not aware of any other models that have the automated multiple route processing capability of Transcost. Therefore, we believe that we should continue to use Transcost to set LRICs for the forthcoming auctions.

Appropriate audit processes for the setting of UCAs.

We believe that Transco should set the UCAs for entry points in accordance with a prescribed methodology which would be subject to both approval by the Authority and suitable audit arrangements.

Chapter 4 – Estimates of UCAs

Levels of proposed UCAs for new entry points

It is our view that when considering the levels of proposed UCAs for new entry points the most important discussions should relate to the assumptions that underlie the estimates of long run incremental costs, rather than the technicalities of the individual models. Therefore, the assumptions of the supply/demand scenario and the baseline used to model the costs become the most influential elements in the modelling.

Levels of the indicative UCAs for existing entry points calculated using the method described in chapter 3

Please refer to above response.

Advantages and disadvantages of not setting UCAs on a cost reflective basis and setting UCAs for new entry points on the basis of benchmark comparisons with existing UCAs

With regard to our licence obligations, we believe that prices should be set on a cost reflective basis in order to promote competition. With this in mind, we believe that reserve prices should be set to be consistent with UCAs as long as the UCAs themselves are cost reflective.

Due to the length of time that has elapsed since the licence UCAs were set and the ongoing changes in supply and demand patterns, it is evident that there will be large step changes in UCAs for the existing entry points. The revised UCAs (and hence revised reserve prices) are likely to lead to significant under-recoveries in entry capacity auctions. We would therefore seek to consult on the appropriate way to reflect this in our charging methodology. For example, it may be necessary to consider some form of non-locational capacity charge or look to extend the current TO commodity charge to deal with large under-recoveries from auctions. Further to the above, we do not believe that Transco would need to consult on a change to the current charging methodology as Ofgem has already consulted on reserve prices within this consultation.

In order to avoid the strong possibility of a similar situation arising in the future, we suggest that in future, UCAs (both for entry and exit) should be amended on an annual basis, as they would then provide a more accurate reflection of the marginal costs of investment over the entire price control period. It would also ensure that an opportunity exists at least once a year to incorporate new entry points. However, we recognise that it may be more appropriate to consider this issue as part of the next price control review.

Any other approaches to setting UCAs that respondents might favour

We have no further comments to make at this time on this point.

Chapter 7 – Further issues for consideration

Views are invited on any aspect of setting UCAs and the associated incentives and in particular on:

the draft principles identified namely,

- **UCAs should be set in a timely way so not to frustrate the legitimate expectations of project developers;**
- **UCAs should reflect long-term costs, be non-discriminatory and facilitate competition between shippers and suppliers;**
- **UCAs should not create perverse incentives, including for the uneconomic bypass of Transco's network;**
- **UCAs should be set via a transparent process and informed by consultation and expert advice**

We support Ofgem's draft principles. However, we also believe that it would be of benefit to add a further principle:

- UCAs should provide sufficient incremental revenue to recover costs incurred by the NTS in providing incremental capacity

It is also for consideration whether UCAs should be set so as to provide stability for project developers and shippers.

For the next price control period Transco should be responsible for setting UCAs (consistent with the approach used with other network operators where the licensee sets prices and Ofgem approves any changes to the underlying methodology).

We would fully support a proposal as part of the next price control period, whereby Transco would be responsible for setting prices.

We agree that Ofgem should approve any changes to the underlying methodology.

Whether there are improvements or useful changes that could be made to the auctions for gas entry capacity

Clearing Price

The NTS entry capacity auctions were designed to ration scarce capacity efficiently in addition to allowing shippers to signal their long-term needs with respect to future entry capacity. The regime was put in place to enable the signals obtained from the long-term auctions, to assist Transco in relation to its investment decisions in responding to changing patterns of supply and demand

At the present time, Transco has a licence obligation to offer for sale capacity in at least one clearing allocation – where a clearing allocation is defined as an auction where either

all the capacity offered for sale is sold or has a reserve price of zero. However, Transco's NTS licence also contains the obligation to offer gas for sale on the gas day, if Transco has not already met its clearing allocation obligation beforehand. In view of this obligation, Transco changed reserve prices for on the day capacity to zero in October 2003. Since that time we have noticed a marked increase in on the day sales, presumably due to the obvious price differentials between securing capacity in a long-term auction at a reserve price, or waiting until the day and paying zero cost. As such, we believe the clearing allocation obligation positively incentivises shippers not to book in the long term auctions – which seems to go against Ofgem's intent for the auction regime to provide Transco with sufficient information from shippers to enhance the planning process.

Indeed, recent experience 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.

Therefore, we would welcome further discussions with Ofgem, in relation to removing this obligation within Transco's NTS GT licence.

Baselines within Transco's NTS GT licence

We believe that the baselines at some entry points, as set within Transco's NTS GT licence, have been shown via bookings to date within the auctions to be too high. The combination of these high baselines together with the clearing allocation obligation, could lead to either incremental investment not being remunerated or insufficient investment signals being received from the long-term auctions. We believe, that the level of baselines to apply in future should be discussed as part of the next price control.

Interactions between entry and exit

As part of the discussions with Ofgem concerning Exit reform, Transco has highlighted the issues around the interactions between entry and exit. We welcome Ofgem's letter on exit reform issued on 24 June in which Ofgem is stating it would be beneficial to consider coordination between work on Entry and Exit as part of the forthcoming Transco NTS price control review. We believe that the two regimes should be developed in tandem so that the correct pricing signals can be issued to shippers and Transco can ensure that any costs for providing incremental capacity (at either entry or exit) can be appropriately remunerated.

Whether UCAs should be used to set reserve prices in some or all of the entry capacity auctions

We believe that UCAs should be used to set reserve prices, as this is consistent with the methodology as contained within the Charging Methodology statement.

The present value test that is used as a trigger for the release of new or additional entry capacity and summarised as follows;

Transco's IECR (incremental entry capacity release) methodology statement specifies a net present value (NPV) test, which requires the NPV of the aggregate value of bids over 8 years to equal at least 50 per cent of the assumed project value. The assumed project value is an estimate of the costs of providing incremental entry capacity and is calculated by multiplying the volume of incremental entry capacity being considered for release by the entry point's UCA. If the NPV of bids for incremental entry capacity over 32 quarters equals at least 50 per cent of the assumed project value for the incremental entry capacity, then Transco will seek approval to release permanent obligated incremental entry capacity.

The present value test forms part of Transco's IECR methodology. Transco NTS under Special Condition C15 has an obligation to review the IECR methodology on an annual basis. We have recently carried out our yearly consultation in relation to the IECR methodology and we welcome industry comments on how it may be improved. We believe that any proposed changes to specific elements of the IECR should be addressed and discussed through the annual review process.

Against this background, Transco NTS considers the NPV test contained in the IECR to be a reasonable proxy to establish when network investment would be efficiently incurred and we have not recently received representations to the contrary.

The best process for setting UCAs including:

At present, Ofgem determines the UCAs but relies on Transco to carry out the modelling which underlies the UCA setting process. It might be more appropriate if in future Transco would have the obligation to set UCAs in accordance with an agreed process. Consideration would need to be given to whether a dispute resolution process would be appropriate

We agree with Ofgem that Transco should be responsible for setting UCAs and that this should be in accordance with a methodology that would be approved by the Authority and subject to suitable audit requirements.

Whether UCAs should be based on standard demand increments or whether these should be bespoke to the circumstances of the entry point

Please refer to our answer provided in relation to the appropriateness of using load absorption.

If a shipper requests a revised UCA and if the higher flow rate requires network reinforcement then there might be a time lag before the additional capacity becomes available

Transco NTS under Special Condition C15 has an obligation to review the IECR methodology on an annual basis. We have recently carried out our yearly consultation in relation to the IECR methodology and believe this issue should be considered through that process.

At present UCAs can be requested at any time for combinations of potential new entry points, resulting in considerable resource implications both for Ofgem and Transco. It might be appropriate to formalise this process such that UCA requests for new entry points could be made twice yearly in dedicated time slots. Also, it might be appropriate to determine the UCAs in a certain fixed time period unless there are exceptional circumstances

We believe that further work is required to develop an appropriate methodology in relation to UCAs. We would welcome further discussions with Ofgem in relation to this issue.

It might be appropriate for Transco to levy a reasonable charge for setting UCAs;

We believe that it is appropriate for Transco to levy a charge for such a service in order that Transco can operate in an efficient and cost reflective manner.

To improve transparency, it might be appropriate to investigate whether an annually updated version of Transcost could be made available to interested parties, and given that gas flows on the network change over time, it might be appropriate to review all existing UCAs on an annual basis rather than on a five yearly basis, given that the former is much more likely to ensure cost reflectiveness.

Transco does not hold the copyright for Transcost. Transcost is a product, which is owned and developed by Advantica. Any release of Transcost for use by interested parties would therefore need to be discussed with both Advantica and Transco. However, we have concerns over the confidentiality of data on a supply or demand point basis.

We agree with Ofgem's statement that UCAs should be reviewed on annual basis to ensure cost reflectivity. However, we recognize that market participants require certainty and stability in order to inform their investment decisions.

Appendix 3 – Ofgem's Draft Impact Assessment

Within this section we provide our comments on the options going forward asked by Ofgem in Appendix 3 of their consultation document.

Option 1

In relation to Ofgem's Option 1, where all UCAs are recalculated, we believe that this meets all the principles for the following reasons

Cost reflectivity

We agree with Ofgem that cost reflective charging is important as it allows market participants to take the costs of transmission into account when deciding where to locate and operate plant. Cost reflective charges should lead to efficient investment signals and as a consequence minimise overall costs to consumers.

These new UCAs provide the best estimates of the current forward looking marginal costs of providing capacity at each of the entry points. They therefore represent the most cost reflective UCAs at this point in time.

Promote competition and be non-discriminatory

Under Ofgem's option 1 all the UCAs will have been calculated on a like for like basis and will be cost reflective, so should give the correct signals to market participants to enable them to inform their investment decisions. Moreover, if only new entry point UCAs were set at this time, this could lead to distortions within the market where it may be beneficial (due to the incorrect price signals indicated via the existing UCAs) for new developers to consider connecting to existing entry points which could involve greater investment which would not provide the economic solution for end consumers.

For the above reasons we believe that option 1 is the most appropriate way forward. However, whilst we support this option, there are certain other factors that need to be considered regarding the timing of the implementation; in particular the potential implications for delaying auctions past September. We would need to consider whether there would be sufficient time to respond to capacity requests from October 2008 if auctions were held later than September, we would encourage customers who may be requesting incremental capacity from 2008 to contact us so that all options can be considered in order to try and facilitate the requests. We would also want to discuss any potential buyback implications with Ofgem.

Option 2

In relation to Option 2, where the new entry points are capped to the level of UCA at a nearby existing entry point, we believe that this option is not appropriate for a number of reasons.

Cost reflectivity

We believe that Ofgem's option 2 does not reflect the principal of cost reflective charging. By capping the new entry point UCAs to an arbitrary level such as the UCA at a nearby exiting entry point we believe that these new UCAs would not provide appropriate

locational signals to new entrants as they will not be cost reflective. In addition some of the choices of nearby entry points do not seem totally appropriate. It does not seem sensible to be using the Isle of Grain as a proxy for Winkfield as they are not really in close geographic proximity and do not share the same feeder.

Promote competition and be non-discriminatory

Whilst it can be argued that Option 2 would be non-discriminatory, it could, however, lead to cross-subsidies between shippers. Ofgem's own analysis shows that this would be the case. In table 5.1 within the consultation document**,** by comparing the UCA for Welton (Beckering or Blyborough) of 0.1275 with that of Easington (0.0375), new entrants would only pay 29% of the cost of capacity at that point, meaning that 71% of the costs would be picked up by other customers. This does not seem appropriate. Furthermore, if Transco were to invest following a signal for capacity at the new entry points, where the UCA had been set under the option 2 method, it is clear that Transco's costs would not be covered by the SO incentive revenue so Transco would be seeking assurances from Ofgem under this approach that its costs would be covered under the forthcoming TO price control.

In addition, it could be argued that by signalling to shippers, at this point in time, of an intent to increase prices at certain existing entry points to be cost reflective in the future, could lead to a situation whereby shippers book as much capacity as they can through the September 2005 auction, as they can lock into the cheaper prices for a 15 year period through that auction. Unanticipated large demands for capacity could result in problems for Transco in meeting its obligations of a 3-year timescale under the Incremental Entry Capacity Release (IECR) methodology. Again, Transco would need further discussions with Ofgem if this were the case.

Consistency with previous regulatory decisions for new entry points

Since the last price control, Ofgem has determined UCAs for several new entry points, Milford Haven, Garton and Barton Stacey. In its June 2003, consultation document on new entry terminals, Ofgem considered that wherever possible the UCA should be set on the best estimate of unit cost of providing capacity at an entry terminal. Therefore, the approach outlined within option 2 is not consistent with previous regulatory decisions for new entry points.

Compatibility with Transco's licence conditions

In addition, we have concerns as to how this option would allow Transco to meet its broader licence conditions such as Standard Special Condition A5 5 (aa) (i) in which Transco has an objective to ensure that the reserve price is set at a level best calculated to promote efficiency and avoid undue preference in the supply of transportation services, as the price signals given to customers would not be cost reflective. However, we consider that as Ofgem has consulted on these UCAs with reserve prices clearly in mind, we would not need to issue a separate pricing consultation on this matter.