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Dear Mark

Initial proposals on transitional incentive schemes supporting the offtake arrangements

This response contains the views of National Grid's distribution business.

We support the concept of incentive schemes covering the acquisition of exit rights by the Distribution Networks under the transitional arrangements. The purpose of these schemes is to align the incentives of network operators with those of the customer. In this way all parties should have an incentive to make the best use of existing capacity and to ensure that new capacity is delivered at the lowest cost, with network operators being neutral to whether the investment is on their network or another. Our comments below focus in particular on those areas where we believe it is possible that the incentives may not work in this way.

Requirement for "DN ARCAs"

The consultation proposes that any DN request for exit capacity that triggers NTS investment will require the DN in question to enter into a contractual agreement with the NTS. It is anticipated that this will entail some form of penalty being paid should the DN subsequently reduce its request for capacity. Both the DNs and NTS have a licence obligation to deliver a network that is secure against 1 in 20 demand levels. If a DN is obliged to guarantee requests for additional capacity that is in line with the NTS's view of 1 in 20 demand levels, this would require the DN to carry some of the financial risk associated the NTS meeting one of its licence/statutory obligations. In other words DNs would have an exposure to NTS forecasting errors. Generally, a rise in 1 in 20 demands will require investment in both the NTS and Distribution Networks. We believe that where parties are investing to meet their own licence/statutory obligations, the equitable solution is for both parties to be allowed to recover the associated costs via their own charging mechanisms. Following this logic, we accept that DNs should have an exposure when requesting capacity over and above the growth rates used by the NTS to compile the Transporting Britain's Energy report. This could be achieved via a DN being obliged to enter into an "ARCA" style contract with the NTS. A detailed methodology would need to be developed to define the rules for when an ARCA were to be required and covering the arrangements at sites with multiple users.

Amending Capacity Rights after the Initial Allocation

The initial proposals do not appear to include any incentive for a DN to return capacity that has been booked, but is subsequently not required. The incentives should encourage both the submission of accurate bookings in the first place and also the return of any capacity that is subsequently not

needed, so that it can be made available to another user. If, as proposed, the DN has no incentive to return surplus capacity, this will work counter to the operation of the incentive to minimise capacity requirements. This will lead to the risk of higher capacity bookings than otherwise, and potentially inefficient investment by the NTS. It would therefore be appropriate for DNs to be credited under the incentive scheme for returning capacity to the NTS and for this to outweigh any contractual penalty payment for cancelling the booking. Such a penalty will also reflect the fact that if the NTS investment for DN exit capacity is not required at the target time, then it will typically be used in the following year or two (assuming gradual DN demand growth). Hence the cost of inefficiency is limited to the time-value of the investment for a year or two.

An alternative approach would be to credit the DN for returned capacity to the extent that either the NTS is able to avoid the associated investment expenditure and/or is able to re-sell the capacity to another party. However, under this approach the value to the DN of returning the capacity would be unknown at the time of making the decision, so making it difficult for the DN to optimise its position. We would therefore favour an approach where the value is fixed at the time when the decision to return the capacity is made.

Interaction with Interruptions Incentives

We recognise that the time scale associated with the introduction of the transitional exit arrangements effectively precludes the possibility of aligning exit and interruption incentives at this point. However, we believe that such alignment will be necessary to achieve all the potential benefits of DNs optimising between investment in incremental capacity and contracting with customers to interrupt on demand. We look forward to future developments in this area.

Retaining the Structure of the Existing Incentive Scheme

We support the proposal to retain the structure of the existing incentive scheme. All parties will have become used to how the scheme operates and will have set up internal reporting mechanisms. We also support the proposal to set the incentive schemes for the duration of the transitional arrangements.

Methodology for setting targets for flat capacity

We note that Ofgem's methodology for setting targets for flat capacity results in a target that is equal to the 1 in 20 demand for gas in the Local Distribution Zone. We believe that this is the correct level. Gas Transporters have a legal obligation to provide sufficient capacity to meet 1 in 20 demands and it would be perverse to either impose a financial penalty on them for meeting this obligation or to reward them for exceeding it by setting a higher target.

Flow Flexibility

The consultation sets targets on the basis that the requirement for Flow Flexibility varies in proportion with the level of demand. This assumption does not allow for the following factors:

- As the volume of gas supplied grows, the total amount of diurnal storage required increases in proportion.
- Diurnal storage to cover for the variation in demand across the day can be derived from either storage within the network or by taking Flow Flexibility from the NTS. Hence the volume of Flow Flexibility purchased is the difference between the level of diurnal storage required and storage available within the DN.
- As the amount of gas transported in a network increases, transmission losses in the pipework also increase. In turn these pressure losses restrict the pipes permissible range of operating pressures,

reducing the ability of the network to provide linepack storage. Hence, as more gas that is transported, the total volume of diurnal storage required increases and the storage available within the network reduces, both increasing the requirement to purchase Flow Flexibility from the NTS.
- As a result, the requirement for Flow Flexibility increases at a much faster rate than demand. We are providing a graph to illustrate this point in an annex, but request that you treat this information as confidential.

This contrasts with the targets quoted in the consultation that appear to work on the basis that it is the requirement for Flow Flexibility alone that increases in proportion with demand. Accordingly, we believe that the current methodology for setting Flow Flexibility targets is unreliable and should be reviewed. We suggest using a method based on the following approach:

- The total requirement for diurnal storage within a network is modelled as increasing in line with load growth
- The DN provides data on the storage available within the DN in terms of both holders and linepack (This data being subject to review/challenge by Ofgem)
- The Flow Flexibility target is set as being the total requirement less the volume of storage available within the network.

Whilst such an approach is more complex, it would allow an accurate assessment of whether the DN's request is simply mirroring movements in demand, or is seeking additional Flow Flexibility over and above that caused by demand growth.

Expected Price of NTS Exit Rights

The consultation proposes in paragraph 4.22 using NTS outturn prices for NTS exit capacity for determining both the reference prices and the companies' performance. Given that Gas Transporters have an obligation to secure sufficient rights to meet 1 in 20 demands and financial incentives to book no more, the main mechanism for lowering costs is to concentrate usage on the exit zones with the cheapest capacity rights. This means that the DNs exposure to price risk is greater than that identified in the consultation as a DN could concentrate its offtake rights in a zone where they were predicted to be cheap, only to find that subsequently the price moved against them. Perversely, the very act of concentrating offtake rights in an apparently cheap zone will tend to increase the prices locally and hence the risk of the DN being exposed. This differs from a normal market in two ways, participants will not have price certainty when entering into a commitment and prices will be updated at periodic intervals rather than immediately responding to supply and demand. Basing the incentive scheme on the NTS prices at the time when most of the capacity is likely to be booked, namely three years prior to capacity usage, could reduce this risk.

Paragraph 4.21 proposes to charge Flow Flexibility at the same price as Flat Capacity on the basis of avoiding undue discrimination between DNs and Directly Connected Customers. However, in reality the two regimes are quite different. A Directly Connected Customer generally has an industrial process and purchases sufficient capacity to allow operation 24 hrs a day. In return the profiles posted are subject only to their NEXA agreement. If Directly Connected customers were subject to the same regime as DNs they would be obliged to purchase Flow Flexibility to cover any variation in flow. Hence, a Direct Connect wanting the freedom to operate 0600 to 2200 and then shut down (i.e. operate two shifts per day) would have a requirement for Flow Flex of 33.3% of their Flat Capacity. Conversely, a DN is required to offtake at a uniform rate unless Flow Flex has been purchased. Ofgem's proposed targets for DNs in 2009/10 allow for Flow Flex volumes 118.70 GWh/day and 4990.10 GWh/day of Flat Capacity: i.e. Flow Flex is 2% of Flat Capacity. Thus, it can be seen that Direct Connects, who are not obliged to buy Flow Flex, can, for their size, impose a much greater level of flow variation on the NTS than DNs who must pay for all flexibility. This inequality undermines the logic that Flow Flex and Flat Capacity must be the same price to avoid undue discrimination between users. Furthermore, given that the pricing of Flow Flexibility will be the mechanism for delivering efficient investment for diurnal storage across the wider network, it is essential that the pricing be cost reflective; prices should be low where additional capacity exists within the NTS and higher where

investment would be triggered. To do otherwise risks inefficient investment decisions, with DNs investing significant sums in their networks to avoid purchasing Flow Flex that could actually be provided very cheaply.

Interaction between Interim and Transitional Incentive Schemes

We are concerned that the way the targets for the transitional incentive scheme have been set disadvantages those parties who responded quickly to the interim scheme. Incentive schemes share the benefits of cost savings between the company and the customer. Generally, the company is allowed to retain the benefits for a period, before targets are reviewed to give the customer a benefit through tighter targets. We note that the targets set for the transitional scheme reflect savings that companies have delivered under the interim scheme. In this way a company responding immediately is allowed to retain the benefits until October 2009, a period of four years. Conversely, a company that delayed responding to the scheme until the second year would not have its targets reduced in the transitional scheme. Such a company would start to receive the benefit a year later but would retain the benefits until October 2011, a period of five years. We believe that companies should achieve the maximum benefit by responding to an incentive scheme immediately and not by delaying. This perversity could be addressed by setting all targets for 2009/10 by scaling offtake quantities in line with the growth rates in Transporting Britain's Energy. The targets in subsequent years could be reduced to allow for savings that have already been delivered, without penalising the companies concerned for their prompt action.

In summary, we support the introduction of transitional incentive schemes to reward network operators for taking efficient investment decisions across the wider transmission/distribution system. With respect to the proposed ARCA-type agreements, we consider that the level of any penalty payment for subsequently reducing capacity requirements should be such that DNs still have an incentive to return surplus capacity. We also believe an ARCA should only be required where the capacity requested is over and above that which the NTS has a licence obligation to provide. We suggest that the incentive scheme for Flat Capacity should be based on NTS prices at the time when DNs booked the capacity, rather than out-turn prices. Finally, in relation to Flow Flexibility, we have concerns over the proposed methodology for setting incentive targets and the lack of cost reflective prices.

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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