

Ref: AW/DM/006

17 October 2005

Mark Feather  
Office of Gas and Electricity Markets  
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SW1P 3GE

Dear Mark

**Initial proposals on transitional incentive schemes supporting the offtake arrangements**

Northern Gas Networks Limited (NGN) welcomes the opportunity to comment on these initial proposals.

Our response to each specific element outlined in the paper is set out below, together with a summary of other more general issues we believe should be addressed within the Final Proposals.

Proposed targets for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity

NGN is concerned at the general premise which runs through the consultation that there is “a tendency for DNs to overbook NTS exit rights”. NGN can confirm that it has requested capacity based on its legal 1 in 20 obligation and that it has used the same methodology as in previous years to estimate exit rights. Consequently, it is inappropriate that the request has been adjusted downwards.

If NGN was to request exit rights in line with the allowance given in the consultation document there would be a risk of us being non-compliant with our legal obligation. If requests for capacity across DNs are reduced then this will indeed lead in the future to the behaviours envisaged by Ofgem of requesting more than is actually required. We are still unclear how Ofgem derived capacity targets for 09/10 and 10/11 and we would welcome the calculation of exactly how these were derived within the incentive scheme proposals. Please note that in table A1.2, the columns headed “DN requests from NTS” do not show the requests made by NGN but show the amounts allocated by the NTS.

We would be happy to discuss with Ofgem the network analysis and calculations underpinning our requests for exit rights to demonstrate that this is the best projection of its requirements and that it has satisfied its primary obligations without overbooking of capacity.

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We propose therefore that NGN's original capacity requests, submitted as a volume with an associated CV, are used as the basis for any incentive targets as a more accurate reflection of the Networks 1 in 20 capacity requirements.

Furthermore, 4.16 states: "the application of growth rates at the LDZ level is appropriate given the potential substitutability of NTS offtake (flat) and NTS offtake (flexibility) capacity between different exit zones within an LDZ". There is not, however, any significant potential to substitute offtake flat or flex in either of NGN's two LDZs. Other DNs may, however, be advantaged more than NGN as they may have more potential for substitution either across exit zones or, in the case of the four retained DNs, across DN boundaries.

#### The most appropriate reference price for NTS exit rights

NGN agrees that it is appropriate to set one price for the determination of NTS flat and flexibility prices as per the interim arrangements. Similarly, NGN recognises that by setting this outturn price at the actual NTS exit price (some three years hence) a level of unknown risk exists in terms of the financial exposure to which a DN is exposed. However, on balance, NGN views this price setting to be appropriate.

Using the outturn price does result in any incentive reward or payment being crystallized some years (3 or 4) after the initial booking of capacity, which it could be argued lessens the focus of DNs when requesting capacity. A more immediate impact on allowed revenue may prove more robust in fully promoting the DN behaviour sought by an incentive scheme.

#### The proposed definition of caps, collars and sharing factors in the DN transitional incentive schemes

NGN agrees with Ofgem's view that the continued use of a 7.5% cap and collar, and a 100% sharing factor (as currently operating within the interim arrangements) is appropriate.

#### The proposal not to define an incentive for cost of greater than 15 day interruptions by DNs at this time

One of the key principles underpinning the incentives is the ability for transporters to manage its capacity by a combination of investment and demand side management. Whilst recognising that a new interruption regime may be forthcoming, this aspiration should not preclude the inclusion of the current interim measures for interruption which form a component part of the complete DN capacity management picture. NGN recommends that this component is included within the transitional scheme so that capacity booking is not distorted by the absence of this element of the scheme.

#### Other Issues

We also have concerns about the proposed ARCA arrangements and we believe that more consideration on how these will work in practice is required before their use is implemented. It is unclear why these arrangements are needed given that the NTS has been provided with substantive investment for reinforcement. Furthermore, the ARCA arrangements are only viable if the DNs can fully back-off the risk to the customer.

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Consequently, ARCAs can only be used for specific new DN connection requirements that trigger the need for a specific Offtake Capacity requirement and are not appropriate for general increases in Offtake capacity as a result of general demand growth within the DN. In addition, ARCAs use NTS Exit capacity (for which shippers pay) as the basis for establishing the ARCA commitment and upon which we assume the ARCA commitment in this instance would also be based. However, the DN's requirement is for Offtake Capacity for which there is no current charge; this results in a potential mismatch of requirements. We believe that ARCAs should not be required for transitional arrangements but should only be considered during discussions on the enduring exit arrangements.

Ofgem has intimated (UNC Transmission workstream, 6 October 2005) that in scenarios where a DN faced a significant financial loss based on the commercial rules within a DN incentive scheme, it may consider a DN seeking recompense under the provisions of an Income Adjusting Event (IAE). Currently the financial threshold for such an event is set at £2,000,000. NGN believes that there is merit in setting a DN related threshold at (say) a percentage of notional NTS Exit right charges. If setting a limit was too arbitrary, it may be more appropriate to signal that IAE events would be considered based on individual DN events, where the relative cost of any loss (versus notional revenue) could be weighed. Were ARCAs to form part of transitional arrangements, NGN particularly sees merit in the provisions of any IAE extending to the potential costs within a DN ARCA.

We would welcome Ofgem's early consideration of these issues, particularly given their link to Modification proposal 0046. The current absence of this proposal's implementation precludes DNs from actually booking its 2005 capacity requests (thus eroding the typically required 3 year investment lead time).

I trust you find these comments helpful. Should you have any questions relating to NGN's response please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Alex Wiseman', with a stylized flourish at the end.

Alex Wiseman  
Regulation Director